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No. 83-598

# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1983

JOSEPH P. MAZZOLA, ROBERT E. BUCKLEY, ROBERT J. COSTELLO, WILLIAM SPENCER, WILLIAM JENNINGS, D. E. DEHNERT, V. J. KAZARIAN, KEITH HANSEN, LAWRENCE J. MAZZOLA, H. J. RIBONI, RAYMOND SPRINGER, STEWART SMITH, FRED CASTRO, and JAMES EMMONS,
*Petitioners,*

vs.

RAYMOND J. DONOVAN, SECRETARY OF LABOR, UNITED STATES DEPARTMENT OF LABOR,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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## QUESTIONS PRESENTED

1. Where there is no evidence that a joint industry board of labor and management trustees of a labor union pension fund ever made an investment which caused the funds to lose money, did the Court of Appeals err in affirming an order removing the trustees from their investment function and appointing, for a term of 10 years, an investment manager of the trial court's choosing?

2. Are trustees of such a board properly removed from the investment function where there has been no showing of any corruption, self-dealing, or bad faith on the part of any trustee, and where the trustees served without compensation?

3. Is failure to invest in the stock market a sufficient reason for removal of trustees from the investment function of a labor union pension fund?

4. To what extent are the good faith investment decisions of duly constituted trustees of an employee benefit fund protected from second guessing in the courts?

5. Did the Court of Appeals properly approve the per se rule of liability of *Cutaiar v. Marshall,* 590 F. 2d 523 (3rd Cir. 1979), holding the trustees per se liable for any losses which might result from an interfund transaction in which the trustees have acted on both sides of the transaction and the participants in the funds are not identical to the man, but are substantially the same people?

6. Is a loan between sister funds of a labor union to be judged by the same standards as a loan between parties which are unrelated to each other?

7. When trustees commit monies of an employee benefit fund for a feasibility study, can the propriety of their actions be judged by the trial court's opinion of the quality of the resulting study, or must the propriety of the trustees' action be judged by facts known to the trustees and available to them at the time the study is commissioned?

## PARTIES IN THE COURT OF APPEALS

The parties to the proceeding in the court below are those named in the caption of the case in this Court, except that in the court below the UA Local 38 Pension Fund and the UA Local 38 Convalescent Fund were co-defendants and co-appellants with Petitioners. The present Petition is not filed on behalf of either the UA Local 38 Convalescent Fund or the UA Local 38 Pension Fund.

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VS.

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

## OPINIONS BELOW

The opinion of the court of appeals is reported at ..... F. 2d ..... (9th Cir. August 23, 1983). It is also reported at ..... Empl. Ben. Cas. (BNA) ..... (9th Cir. 1983). The court of appeals opinion in this case is reprinted as Appendix A. The findings and conclusions and the judgment of the trial court are reported at 2 Empl. Ben. Cas. 2115 (N.D. Ca. 1981). The findings and conclusions of the trial court are reprinted as Appendix B (pp. A-34 to A-89) and the judgment of the trial court is reprinted as Appendix C (pp. A-90 to A-98).

## JURISDICTION

The decision of the court of appeals was entered on August 23, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

## STATUTORY PROVISIONS INVOLVED

29 U.S.C. § 1104, which discusses the fiduciary duties under ERISA provides in its entirety:

> (a) (1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.
>
> (2) In the case of an eligible individual account plan (as defined in section 1107(d) (3) of this title), the

diversification requirement of paragraph (1) (C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

(b) Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)—

(1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

29 USC § 1106(b)(2) provides:

(b) A fiduciary with respect to a plan shall not—

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. . . .

29 USC § 1109(a) addresses the liability for breach of fiduciary duty. This section provides:

(a) Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 1111 of this title.

## STATEMENT OF THE CASE

This is an action under the fiduciary responsibility sections of ERISA. Plaintiff is the Secretary of Labor and defendants are 14 individuals who are trustees of the U.A. Local 38 Trust Funds in San Francisco. U.A. Local 38 is not a party. It is a union of plumbers and pipefitters having approximately 1900 members. Also parties defendant are the U.A. Local 38 Pension Fund and the U.A. Local 38 Convalescent Fund. The Pension Fund pays retirement benefits to members of Local 38. The Convalescent Fund owns a resort facility at Clear Lake in Northern California, called the Konocti Harbor Inn. Konocti is open to the public, but it also serves as a vacation and recreation facility for members of Local 38 and as a summer camp for children of the members. Also, several retired members of Local 38 live at Konocti in an area known as Lakeside

Haven. The Konocti facilities are available to the members of Local 38 at reduced rates. The principal source of income of the Pension Fund and the Convalescent Fund is employer contributions negotiated and provided for in the collective bargaining agreements between Local 38 and the multi-unit employer associations whose members employ the services of members of Local 38.

The board of the U.A. Local 38 Pension Fund is a joint industry board made up equally of representatives of Local 38 and the employers. The labor trustees are headed by Joseph P. Mazzola, who has been the head of Local 38 for 39 years. During most of the pertinent time period, the same persons were the trustees of both the Pension Fund and the Convalescent Fund, and also of the several other employee benefit funds of Local 38. In the late 1970's, an independent trustee of the Convalescent Fund was appointed; however, the regular trustees served as an advisory committee to him.

This case was instituted in 1979 under the newly enacted provisions of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.). The plaintiff Secretary of Labor singled out a number of transactions for attack. Among these was a 1975 loan of $1.5 million from the Pension Fund to the Convalescent Fund. Also attacked by plaintiff was an expenditure of $250,000 in 1977 for a feasibility study for Konocti. There are four other transactions in issue in this case. They are two extensions and a six month moratorium on indebtedness of the Convalescent Fund to the Pension Fund, and a loan of $650,000 in 1979 from the Pension Fund to a resort hotel in Santa Rosa, California.

The trial court found in favor of plaintiff on every issue. The court found that the $1.5 million loan violated 29 U.S.C. 1104 and 1106 and that the $650,000 loan violated 29 U.S.C. 1104. There is no evidence in this record that either loan has resulted in any loss to the Pension Fund. After the trial court judgment in this case, payments on the $650,000 loan became delinquent, but that does not mean that full interest and principal cannot be collected from the security for the loan.

The trial court held the trustees personally liable for any losses which may result in the future from the $1.5 million loan and the $650,000 loan, and required them to post a $1 million bond as security for these possible future losses.

Plaintiff sought no monetary relief with respect to the extensions or the moratorium. The trial court found that the extensions and the moratorium violated both 29 U.S.C. 1104 and 1106.

Finally, the trial court found that the $250,000 expenditure for the feasibility study on Konocti violated section 1104. The trial court found that the study was worth only $50,000 and ordered the trustees to pay to the Pension Fund $200,000 plus interest. The trial court also found that the 1975 loan of $1.5 million from the Pension Fund to the Convalescent Fund should have been made at 10% interest instead of 8½%. The difference is approximately $110,000 over the pertinent period of time, and the trial court directed the trustees to pay this amount to the Pension Fund. The trustees' liability on the feasibility study and on the interest differential is referred to as the restitution portion of the judgment.

Thus the judgment in this case resulted in substantial financial liability to the individual trustees. They are jointly and severally liable to the Pension Fund for any possible future losses resulting from the $1.5 million loan in 1975 to the Convalescent Fund and for any possible future losses to the Pension Fund from the 1979 loan of $650,000 to the Convalescent Fund. The judgment of the trial court provides that the trial court will in the future hold hearings to determine whether any losses have resulted from these two loans. In the interim, the judgment of the trial court requires the defendant trustees to post a $1 million indemnity bond to secure the Pension Fund against any losses from these two loans. In addition, the trustees are liable to repay the interest differential ($110,000) and the damages found in connection with the feasibility study ($200,000.00 plus interest of $80,000).

In addition to financial liability, the judgment of the trial court orders the removal of the trustees from any investment function on behalf of the Pension Fund. The judgment provides for appointment of an investment manager selected by the trial court. The investment manager is to serve for 10 years. As appears from the trial court's judgment, Appendix C, pp. A-93 to A-95, the powers conferred upon the investment manager by the trial court exceed the investment function.

The court of appeals affirmed the judgment of the trial court in every respect.

## REASONS FOR GRANTING THE WRIT

### I.

### This Case Presents Several Important Issues Dealing With the Interpretation of the Fiduciary Responsibility Sections of the Employee Retirement Income Securty Act of 1974.

By reason of actions usually brought by the office of the Solicitor of Labor, there is a growing body of case law in the district courts and the courts of appeals dealing with fiduciary responsibility under ERISA. *Marshall v. Teamsters Local 282 Pension Trust Fund*, 458 F.Supp. 986 (E.D. N.Y. 1978); *Morrissey v. Curran*, 567 F.2d 546 (2d Cir. 1977); *Marshall v. Snyder*, 572 F.2d 894 (2d Cir. 1978); *Marshall v. Kelly*, 465 F.Supp. 341 (N.D. Okla. 1978); *Eaves v. Penn*, 587 F.2d 453 (10th Cir. 1978); *Cutaiar v. Marshall*, 590 F.2d 523 (3rd Cir. 1979); *Freund v. Marshall & Ilsley Bank*, 485 F.Supp. 629 (D. Wisc. 1979); *Marshall v. Glass/Metal Ass'n & Glaziers and Glassworkers Pension Plan*, 507 F.Supp. 378 (D. Hawaii, 1980); *M&R Investment Co. v. Fitzsimmons*, 685 F.2d 283 (9th Cir. 1982); *Donovan v. Bierwith*, 680 F.2d 263 (2d Cir. 1982); *Sinai Hospital of Baltimore v. National Benefit Fund for Hospital & Health Care Employees*, 697 F.2d 562, 565 (4th Cir. 1982); *Davidson v. Cook*, No. 81-0913-R (E.D. Va., June 30, 1983); *Katsaros v. Cooley*, CV 81-2277 (E.D.N.Y., July 21, 1983). However this Court has never ruled upon the many important fiduciary responsibility issues in ERISA, and the present case presents an appropriate case in which to do so, for the reasons which follow.

We start with the proposition that the trustee defendants in this case have never been found guilty of any conduct

worse than imprudence. There is no evidence in this record that any trustee ever benefited, monetarily or otherwise, by reason of his actions as trustee. Nor is there any evidence of dereliction of duty, gross negligence, or bad faith. Upon this record the Court must conclude that the trustees went about their business in good faith, endeavoring, as best they were able, to maximize the benefits of the participants of the funds committed to their trust.

In 1979 at the instigation of a San Francisco bank, the Redwood Bank, which had recently been deprived of the deposit of U.A. Local 38 Pension Fund assets, the plaintiff filed this suit and began second-guessing various of the Pension Fund's investments.

The trustees preferred to put trust assets into Northern California real estate, especially where construction was involved, since this generated both jobs for members of Local 38 and contributions to the Pension Fund. Thus, both of the big loans in issue here, the $1.5 million loan to Convalescent in Lake County and the $650,000 loan to S&F Spas in Santa Rosa, generated employment for members of Local 38 and employer contributions to the Pension Fund.

Similarly the feasibility study on Konocti was aimed at improving operations, turning around its history of losses, and achieving a maximum long range profit. This would benefit both the Pension Fund, which was in 1977 a substantial creditor of the Convalescent Fund, and the Convalescent Fund itself, whose participants were, with a few exceptions, the same persons as the participants of the Pension Fund.

Instead of considering the context in which the feasibility study was commissioned, the government attacked the quality of the study itself, but the trustees did not have the benefit of judging the study at the time it was commissioned. Nor do the trustees agree that it was worth less than $250,000. The study is yet to be implemented and may turn out to be an enormous benefit to the funds.

In this case the parties stipulated to the facts, and trial consisted almost entirely of expert opinion testimony. The trustees believe that their biggest fault was that their investment philosophy was different from that of the government's experts. The government experts testified favorably to various forms of stock market investments, and the trustees in the present case have consciously avoided such investments, having none of the Pension Fund assets in the stock market, because of its volatility and the fact that such investments bring no indirect benefit to the participants, such as employment or increased contributions.

In the court of appeals, the court rejected the notion that ERISA leaves to the trustee any ambit of discretion or business judgment such as the common law accorded to trustees. III A. Scott, The Law of Trusts, § 187. Thus the case at bar is a very dangerous precedent to the independence and self-determination of many industry funds throughout the country. Where the government does not agree that investments have in its opinion been properly diversified, the government can step in and remove the trustees from the investment function, as was done here. The case at bar presents a very extreme opposition between the culpability of defendants conduct and the severity of the remedies imposed.

**Moreover, duly constituted trustees should be free to invest and expend pension fund assets according to their own best judgment, as opposed to the judgment of the government's expert witnesses.**

There is a technical objection to the finding of liability on the 1975 loan of $1.5 million to the Convalescent Fund. At trial, the trial court fixed on a pre-trial stipulation that the participants or beneficiaries of the Pension Fund and the Convalescent Fund were not identical to the man. Solely on the basis of this stipulation, the trial court applied a rule of per se liability under 29 U.S.C. 1106 and the case of *Cutaiar v. Marshall,* 590 F.2d 523 (3rd Cir. 1979), due to the fact that the same trustees acted on both sides of that transaction. The trial court refused to hear evidence of the substantial identity of the participants or beneficiaries of the two funds, which are both Local 38 Trust Funds. Nor was it important to the lower courts that the trustees were not in any event acting in their own interest. Instead of applying a rule of per se liability, the trial court should have received the evidence of substantial identity and considered whether, since the beneficiaries are the same people, the trustees might not have an overall objective which transcends the interest of a single fund. For example, if a health and welfare fund is in need of a loan, the trustees of a sister pension fund might be disposed to grant it, where the participants of the funds are the same and the health and welfare fund cannot obtain the loan elsewhere. This presupposes that the loan is not particularly advantageous to the pension fund. The trustees may justly consider that this disadvantage to the pension fund is offset by the benefit to the health and

welfare fund. *Cutaiar v. Marshall*, 590 F.2d 523 (3rd Cir. 1979) was wrongly decided. A per se rule of liability should not be applied in a situation such as the 1975 loan of $1.5 million from the Local 38 Pension Fund to the Local 38 Convalescent Fund. Both the trial court and the court of appeals did so in this case, the court of appeals holding that only a special exemption under 29 U.S.C. 1108(a) would relieve the per se liability under 29 U.S.C. 1106 where the same trustees act on both sides of an interfund transaction. The effect of the decision is to prohibit interfund transactions or to require that each benefit fund have a separate set of trustees, each set of trustees being concerned only with the financial condition of its own fund. Local 38 has several funds in addition to Pension and Convalescent. They are Health and Welfare, Vacation, Jury Duty, Supplemental Employment Benefits, Scholarships, Security Savings, and others. The same persons at any given time are the trustees of all of these funds. In this, Local 38 is typical of many labor unions and corporations which maintain employee benefit funds. The *Cutaiar* rule, which was reaffirmed by the court of appeals in this case, should be reexamined.

## CONCLUSION

The relief accorded by the lower courts is momentous. Trustees guilty of no self-dealing or bad faith have been saddled with substantial financial liability and removed from their function as investors of the funds of which they are the duly constituted trustees. The decisions below tell trustees everywhere to quit their unpaid service to their industries and to turn everything over to a big bank, lest they suffer personal financial liability, the spectacle of

removal from their functions, and all the other unpleasantness of litigation. This Court should encourage autonomy and self-determination of private industry groups, not the abdication of responsibility which the decisions below leave as the fiduciary's wisest choice.

For all of the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

LAWRENCE ALIOTO
*Attorney for Petitioners*

**Appendix A**

No. 82-4527
82-4623

D.C. No. 79-0134-SAW
United States Court of Appeals
for the Ninth Circuit

Raymond J. Donovan,
Secretary of Labor, United States Department of Labor,
Plaintiff-Appellee,

vs.

Joseph P. Mazzola, Robert E. Buckley, Robert J. Costello, William Spencer, William Jennings, D. E. Dehnert, V. J. Kazarian, Keith Hansen, Lawrence J. Mazzola, H. J. Riboni, Raymond Springer, Stewart Smith, Fred Castro, James Emmons, The U. A. Local 38 Convalescent Fund, and the U. A. Local 38 Pension Fund,
Defendants-Appellants.

[Filed Aug. 23, 1983]

OPINION

Appeal from the United States District Court
for the Northern District of California
Stanley A. Weigel, District Judge, Presiding
Argued and submitted May 11, 1983

Before: Stewart,* Associate Justice, and Duniway, and Alarcon, Circuit Judges

Alarcon, Circuit Judge:

These are companion appeals from two judgments of the district court. Appellants are certain present and former members of the Board of Trustees of the Pension Fund of Local 38 of the United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry (Local Union 38), as well as the Union's Pension Fund and Convalescent Fund. First, appellants appeal the judgment wherein the district court found that the individual appellants breached their fiduciary duties under the Employee Retirement Income Security Act of 1974, (ERISA) 29 U.S.C. §§ 1001 *et seq.* Second, appellants appeal the district court's judgment finding the individual appellants in contempt of court because they failed to post a $1 million indemnity bond as previously ordered by the court. We affirm the district court's judgment in each case.

## BACKGROUND

Because the district court's findings are not clearly erroneous, we affirm the findings and incorporate them into our discussion. Fed. R. Civ. P. 52(a); *see also M & R Inv. Co., Inc. v. Fitzsimmons,* 685 F.2d 283, 285 (9th Cir. 1982).

Local Union 38 is a Northern California labor union. In 1953, the union and employers of its members established the union's "Pension Fund" to provide retirement benefits to union members and their beneficiaries. The

*Hon. Potter Stewart, Retired Associate Justice, United States Supreme Court.

Pension Fund is an employee benefit plan as defined by ERISA, 29 U.S.C. § 1002(3), and, therefore, subject to ERISA coverage, 29 U.S.C. § 1003(a). The individual appellants as trustees of the Pension Fund, were fiduciaries with respect to the Pension Fund under ERISA, 29 U.S.C. § 1002(21)(A).

In 1956, the Convalescent Fund of Local Union 38 was established by the union and the signatory employers. The Convalescent Fund owns and operates a hotel, the Konocti Harbor Inn, which provides rooms at discounted prices, a summer camp, and a low-cost retirement housing project for participants of the Convalescent Fund and their families. From January 1, 1975 through November 30, 1978, the individual appellants also served as trustees of the Convalescent Fund. Thereafter, they served as an "Advisory Committee" to the sole trustee of the Convalescent Fund.

The participants of the Pension Fund and Convalescent Fund although substantially the same are not identical. Since January 1, 1975, the Convalescent Fund has had more participants than the Pension Fund. The eligibility requirements of the two funds have also differed. Moreover, some contributing employers of the Pension Fund have not been at the same time contributing employers of the Convalescent Fund.

Between January 1, 1975, the effective date of ERISA, and 1979, when the present action was initiated, the individual appellants, as trustees of the Pension Fund, engaged in several transactions that prompted the Secretary of Labor under 29 U.S.C. § 1132(e), to bring this action

charging the individual appellants with numerous violations of ERISA. In December 1975, the individual appellants made a $1½ million loan of Pension Fund assets to the Convalescent Fund. The following year, they granted a moratorium on that loan as well as all other loans that the Pension Fund had made to the Convalescent Fund. When granting the moratorium they did not request amendments favorable to the Pension Fund on the terms of the loans, nor did they require any additional security. In 1978 and 1979, the individual appellants also granted the Convalescent Fund two extensions to repay a $500,000 loan originally granted in December 1974 and due November 1, 1978. When these extensions were granted the amount owed on the final payment was in excess of $400,000. In spite of this, the individual appellants did not alter in any way the terms of that loan, nor did they seek or receive additional security. The Secretary charged that in making the above, the individual appellants violated 29 U.S.C. §§ 1104[1] and 1106(b)(2)[2].

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[1]29 U.S.C. § 1104, which discusses the fiduciary duties under ERISA, provides in its entirety:

(a)(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

In March 1977, Dr. Schwartz, a friend of an individual appellant and personal physician for another, was retained and paid $250,000 by the trustees to perform a feasibility study to determine the most profitable use of the Con-

---

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.

(2) In the case of an eligible individual account plan (as defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

(b) Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary)—

(1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

[3]29 U.S.C. § 1106(b)(2) reads:

(b) A fiduciary with respect to a plan shall not—

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. . . .

valescent Fund's Konocti Harbor Inn. The Secretary contended that a comparable study of equal or superior quality could have been obtained for substantially less money. Thus, the Secretary charged that the individual appellants breached their fiduciary duties under 29 U.S.C. § 1104.

In addition to the loans made to the Convalescent Fund, in 1975, the individual appellants made a loan of $650,000 of Pension Fund assets to a limited partnership known as S & F Spas for the conversion of a hotel to a health spa. One of the principals of the limited partnership was Dr. Schwartz. Prior to making this loan the Pension Fund trustees had approved a $2¼ million construction loan secured by the property on which the spa was to be constructed. The Secretary claimed that in approving the $650,000 loan, the individual appellants breached their fiduciary duties under 29 U.S.C. § 1104.

The Secretary also asked the district court: (1) to enjoin permanently the individual appellants from violating their fiduciary duties to the Pension Fund or any other employee benefit plan; (2) to remove them from service as fiduciaries of the Pension Fund; (3) to enjoin them for five years from serving as fiduciaries of any employee benefit plan covered by ERISA and appoint suitable successor fiduciaries; (4) to rescind all transactions between the Pension Fund and the Convalescent Fund which the individual appellants caused to be entered into; and were in violation of ERISA; and (5) to direct the individual appellants to reimburse the Pension Fund for any present or future losses stemming from violations of the individual appel-

lants' fiduciary obligations. The Secretary also sought costs of the suit and any further relief the district court deemed appropriate.

After a trial on stipulated facts before a magistrate, both parties submitted objections to the magistrate's recommendations. In its findings of fact and conclusions of law filed on November 17, 1981, the district court made a *de novo* determination of all the portions of the magistrate's recommendation to which objections were made. Upon reviewing the record and making extensive findings of fact, the district court concluded that the Pension Fund trustees' actions were to be reviewed under the objective "prudent person" test. Applying the prudent person test, the district court concluded that the individual appellants had breached their fiduciary duties under ERISA as alleged by the Secretary.

Specifically, the district court found that the individual appellants violated § 1104(a)(1)(B) because the challenged loans and extensions of credit were not ones that a reasonably competent lender would have made, nor were they made using accepted procedures used by such a lender. In addition, the district court found that the challenged loans and extensions of credit were in violation of 29 U.S.C. § 1104(a)(1)(A) because they were not made for the exclusive purpose of benefiting the Pension Fund. Both the Convalescent Fund loan and the S & F Spas loan also violated the diversification requirement of 29 U.S.C. § 1104(a)(1)(C). The convalescent loan was also a prohibited transaction in violation of 29 U.S.C. § 1106(b)(2) because the individual appellants acted on both sides of

the transaction. Finally, the district court found that the trustees had not complied with accepted industry standards in selecting a consultant to perform the feasibility study of the Konocti Harbor Inn and had thereby imprudently discharged their duty in violation of § 29 U.S.C. 1104(a)(1)(B). By overpaying Dr. Schwartz for the study, the trustees also violated 29 U.S.C. § 1104(a)(1)(A).

Pursuant to 29 U.S.C. § 1109(a)[3] the district court subjected the individual appellants to joint and several liability for losses resulting from breaches of their fiduciary duty. The district court granted restitution for the losses incurred by the Pension Fund as a result of loaning the $1½ million at a reduced interest and paying an excess price for the feasibility study. The district court also ordered the individual appellants to post a $1 million indemnity bond to insure against potential future losses to the Pension Fund resulting from the $1½ million Convalescent Fund loan and the $650,000 S & F Spa loan. The bond was due sixty days from the entry of judgment. In addition, the district court found it appropriate to appoint an investment manager to control the Pension Fund's

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[3]29 U.S.C. § 1109(a) addresses the liability for breach of fiduciary duty. This section provides:

> (a) Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 1111 of this title.

investment and financial component for a term of ten years. In all other respects the individual appellants were permitted to act as trustees of the Pension Fund. The district court entered its judgment accordingly on July 9, 1982. Appellants moved the district court under Fed. R. Civ. P. 59 for a new trial or to alter or amend the judgment. The district court denied their motion on September 7, 1982. The district court also denied appellants' motion for a thirty-day extension of time to post the $1 million bond. Appellants timely filed an appeal from the judgment entered on July 9, 1982.

On September 13, 1982 the Secretary applied to the district court for an order to show cause why appellants should not be held in contempt for failing to post the $1 million bond as ordered in the judgment of July 9. The district court granted the Secretary's application and directed the Pension Fund trustees to show cause why they should not be held in contempt.

After a hearing on September 30, 1982, the district court found the individual appellants in contempt and granted them until November 2, 1982 to purge themselves of the contempt before incurring penalties. The Court warned that failure to comply would result in penalties of $100 per day for each trustee. On October 22, 1982 appellants timely appealed from the contempt judgment.

## ISSUES

On appeal appellants essentially contend that the district court erred by: (1) substituting its own judgment with regard to the amount of interest the individual appellants should have charged for the $1½ million loan to the Con-

valescent Fund; (2) holding that the individual appellants overpaid Dr. Schwartz for the feasibility study; (3) imposing the $1 million bond; (4) appointing an investment manager for the Pension Fund and (5) finding the individual appellants in contempt of court for failing to post the $1 million bond.

## DISCUSSION

We discuss each issue separately and set forth the district court's findings and conclusions pertinent thereto in our analysis. Before addressing appellants' specific contentions, we must first determine whether the district court applied the appropriate test when examining the challenged actions of the individual appellants.

Appellants suggest that the appropriate test for reviewing the disputed transactions is the "business judgment rule." The record demonstrates that the district court applied the prudent person test. Our review of the applicable ERISA statute, its legislative history, and relevant case law convinces us that the district court applied the proper legal standard to the disputed transactions.

The standard of care imposed upon fiduciaries by ERISA is contained in 29 U.S.C. 1104(a)(1)(B) which provides in relevant part:

> . . . a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (B) with the *care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims* . . . (emphasis added).

The explicit language of this section indicates that the prudent person test applies to fiduciary obligations under ERISA. Case law and the legislative history of ERISA both demonstrate that the source for the prudent person test set forth in § 1104(a)(1)(B) is the prudent person test as developed in the common law of trusts.[4] *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978); *Morrissey v. Curran*, 567 F.2d 546, 548-49 (2d Cir. 1977); *Marshall v. Teamsters Local 282 Pension Trust Fund*, 458 F. Supp. 986, 990 n.8 (E.D.N.Y. 1978); S. Rep. No. 93-127, 93d Cong., 2nd Sess., *reprinted in* 1974. U.S. Code Cong. & Ad. News 4838, 4864-66.

The legislative history also instructs courts to interpret the prudent person rule "bearing in mind the special nature and purpose of employee benefit plans." H.R. Rep. No. 93-1280, 93d Cong., 2d Sess., *reprinted in* 1974 U.S. Code Cong. & Ad. News at 5083; *accord Marshall v. Glass/Metal Assn. & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. 378, 383 (D. Ha. 1980). ("[Section 1104] establish[es] uniform federal requirements to be interpreted both in the light of the common law of trusts, as well as with a view toward the special nature, purpose, and importance of modern employee benefit plans.").

Courts have also recognized that in enacting ERISA Congress made more exacting the requirements of the common law of trusts relating to employee benefit trust funds. *See Sinai Hospital of Baltimore v. National Benefit*

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[4]At common law the prudent person rule applied to trustee investment decisions. *See* III *Scott on Trusts* § 187.2, at 1314 and n.2; §§ 227-227.3, at 1805-12.

*Fund for Hospital & Health Care Employees*, 697 F.2d 562, 565 (4th Cir. 1982).

Our review of the record convinces us that the district court properly applied the prudent person test. As to each transaction the district court considered whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment. *See, e.g., Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982), *cert. denied*, 103 S.Ct. 488 (1983); *Marshall v. Glass/Metal Ass'n.*, 507 F. Supp. at 384; III A. Scott, *The Law of Trusts*, § 227.1-2 at 1809-11 (1967) (hereinafter cited as *Scott on Trusts*), § 227.3 at 1811-12.

## THE $1½ MILLION LOAN

Prior to January 1, 1975, the effective date of ERISA, the Pension Fund had already granted the Convalescent Fund $5½ million in loans. In December 1975, the individual appellants, as trustees of the Convalescent Fund, sought from themselves, as trustees of the Pension Fund, a $1½ million loan of Pension Fund assets. As trustees of the Pension Fund, the individual appellants granted the loan. When the $1.5 million loan was granted, the Convalescent Fund was in poor financial condition as evidenced by substantial operating losses and its inability to make regular payments on previous loans from the Pension Fund and a bank loan.

Before granting the loan the individual appellants also failed to ascertain the value of the property which the Convalescent Fund deeded as security for the loan. Although the Convalescent Fund's total property holding was ap-

praised at $16 million, the Pension Fund received as security only that part of the property which did not include the resort facilities. The value of the property actually given as security was never determined. Moreover, a portion of the property offered as security was subject to prior rights of a bank and already was security for the Pension Fund's $5½ million loan to the Convalescent Fund. The individual appellants, in granting the $1½ million loan, failed to ascertain the extent to which the Pension Fund's interest in the property deeded as security would be subordinate to other security interests.

A government witness, Joseph Azrack, gave expert testimony regarding the prevailing standards to be applied by competent real estate lenders in making, pricing, and managing real estate secured loans. After reviewing the individual appellants' actions with regard to the $1½ million loan, the expert witness noted several deficiencies in the manner in which trustees approved the loan. He opined that the individual appellants' conduct regarding this loan did not meet industry standards.

With regard to the $1½ million loan, the district court found that the individual appellants violated 29 U.S.C. § 1104(a)(1)(B) by failing to follow reasonably acceptable procedures. In addition, the district court also found that they violated 29 U.S.C. §§ 1104(a)(1)(A) and (B) because: (1) they failed to ascertain the identity and value of the loan security; (2) they knew or should have known the loan presented an unreasonable risk of not being timely and fully paid without resort to the collateral; (3) they granted the loan below the prevailing interest rates for comparable mortgages at that time; (4) they acted on both sides of the

loan transactions; and (5) they consistently transacted business with and for the Convalescent Fund at all relevant times for the purpose of aiding the Convalescent Fund at the expense of the Pension Fund. The district court found that the $1½ million loan violated the diversification requirement of § 1104(a)(1)(C).

On appeal appellants challenge the district court's conclusion that they violated their fiduciary obligations under ERISA by granting the loan below the prevailing interest rates for comparable mortgages at that time.

After reviewing the record we are convinced that the district court had ample basis to conclude that the trustees violated their fiduciary obligation by granting the loan at 8.5 percent interest. The Secretary's expert witness testified that the interest rate on long-term commercial mortgages at the time the $1½ million loan was made ranged from 9.75 percent to ten percent. This was over one percent more than the interest rate actually allowed on the loan. The expert witness further testified that because the loan was secured by a resort, rather than an office building, shopping center or industrial property, the loan would have been priced one to three percent above the commercial rate. In addition, the expert testified that in light of California's usury law, a lender confronted with the possibility of making this loan would have chosen making the loan within the statutory ceiling of ten percent, making an out-of-state real estate loan, or making another sort of investment. Based on this evidence the district court properly concluded that the individual appellants breached their fiduciary duty by lending the money at 8.5 percent interest.

Appellants assert, however, that the expert's testimony was inadequate to support the district court's finding of an ERISA violation on this point because the testimony was based on a chart admitted solely for illustrative purposes. We find their argument meritless. The witness testified that he prepared the chart from sources that an expert in real estate development would ordinarily rely on to determine the interest rates during the period relevant to this loan. Based on the information provided by those sources, the expert opined that, absent California's usury ceiling, the prevailing rates for this type of loan would have been one to three percent higher than the 9.7 to ten percent listed on the chart. At the hearing, appellants made no attempt to cross-examine the expert on this point. On appeal, appellants cite nothing in the record which contradicts the expert's testimony.

Appellants contend that the difference between the interest rate actually charged and the interest rate which the district court found should have been charged was too small to warrant a finding of imprudence. We find this argument to be without merit. Appellants haved failed to demonstrate that the district court's determination that a reasonably prudent trustee would have required a ten perent interest rate, rather than the 8.5 percent rate actually charged, is clearly erroneous. *See* Fed. R. Civ. P. 52(a). The difference between the two rates added up to a loss of over $110,000 since the loans were made. We cannot conclude that this sum is insubstantial.

## FEASIBILITY STUDY

In April 1977, the individual appellants as trustees of the Pension Fund selected Dr. Ernest Schwartz to prepare a feasibility study designed to inform them of the manner in which the Convalescent Fund could best use the Konocti Harbor Inn property. The individual appellants never inquired into Dr. Schwartz's qualifications to prepare the study. The evidence shows that Dr. Schwartz never made a feasibility study, or written a report on the potential markets and customers for a recreational facility, and had not specialized in advising others as to recreational resort properties or other specific types of real estate. Indeed, the individual appellants never discussed Dr. Schwartz's oral proposals with any consultants or experts, nor did they interview or solicit bids from other potential consultants. Although Dr. Schwartz did not complete the study until September 1977, the individual appellants paid him the entire $250,000 which he had requested as payment for the study in June 1977.

After submitting the study to the individual appellants, Dr. Schwartz did not extensively discuss its implementation with them nor did he give them further guidance or advice regarding the contents of the study. Moreover, he did not perform any follow-up service or submit any update to the study.

In the proceedings below, the Secretary presented expert testimony regarding the prevailing standards for selection of a consultant to perform a feasibility study. In essence, the expert testified that the prevailing practice was to obtain bids and written proposals from several consultants

and to withhold some portion of the consultant's fee pending satisfactory completion of the study.

The individual appellants' failure to inquire into Dr. Schwartz's qualifications and to follow the generally recognized procedures for selection of a consultant refutes their assertion that they took a "conscientious and deliberative approach" toward this $250,000 expenditure of Pension Fund assets. Indeed, the appellants do not challenge the district court's finding that the Secretary's expert witness correctly stated the prevailing industry standards and that their conduct was deficient because they failed to follow those procedures. Instead, relying on § 201 of III *Scott on Trusts,* appellants merely assert that they did not violate ERISA by acting imprudently because they relied on counsel's advice that the $250,000 expenditure conformed to ERISA requirements. This asserted defense fails. Nothing in the record supports their contention that they received any advice from counsel on this matter. Even if such advice had been received, reliance on counsel's advice, without more, cannot be a complete defense to an imprudence charge. *See, e.g., Donovan v. Bierwirth,* 680 F.2d at 272. Moreover, the section in *Scott* relied on by appellants is part of a discussion of when a trustee is *not* negligent and breaches a duty based on a mistake of *law* due to advice of counsel. III *Scott on Trusts,* § 201, at 1651. Here, in retaining Dr. Schwartz to perform the feasibility study the individual appellants' actions can hardly be deemed "*not* negligent." Moreover, their breach of duty under ERISA was not based on a mistake of law. Their breach stemmed from their failure to follow acceptable

procedures in retaining a consultant to perform the feasibility study.

With regard to investment decisions of a trustee and reliance on counsel's advice *Scott* provides:

> In reaching his conclusion [the trustee] may take into consideration advice given to him by attorneys, bankers, brokers and others whom prudent men in the community regard as qualified to give advice. He is not justified, however, in relying wholly upon the advice of others, since *it is his duty to exercise his own judgment in the light of the information and advice which he receives.*

*Id.* § 227.1 at 1809. (emphasis added).

Thus, in evaluating an allegation of imprudence under ERISA, reliance on counsel's advice is, at most, a single factor to be weighed in determining whether a trustee has breached his or her duty.

On the record before us and in light of the individual appellants' failure to inquire into Dr. Schwartz's qualifications and to follow accepted standards for hiring a consultant, we agree with the district court's conclusion that the Pension Fund trustees acted imprudently by paying Dr. Schwartz $250,000 for the feasibility study and thereby breached their fiduciary duty under § 1104(a)(1)(B) of ERISA.[5] *See, e.g., Marshall v. Glass/Metal Ass'n.*, 507 F.Supp. 378, 384 (D. Ha. 1980) (trustees violated their fiduciary duties under § 1104(a)(1)(B) of ERISA by com-

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[5]Appellants' assertion that the prohibited transaction rules of § 1106 are inapplicable to Dr. Schwartz's study is irrelevant. The Secretary charged the Pension Fund trustee with a violation of § 1104. The applicability of § 1104 is in no way affected by the applicability of § 1106.

mitting pension plan assets without adequate procedures or evaluation of the risks involved and alternatives available).

Appellants have also failed to demonstrate that the district court clearly erred in finding that the study was worth only $50,000. Dr. Schwartz kept no record of the amount of hours spent on the project. The Secretary's expert testified that a professionally completed feasibility study of acceptable quality, covering the same subject areas as the Schwartz study, would have cost the trustees no more than approximately $100,000 in 1977 dollars. The expert specified numerous deficiencies in the Schwartz study. He noted that: it largely failed to reach specific conclusions regarding recommendations as to each key subject area; it did not provide any substantial market analysis; it did not develop a coordinated program for physical development of the many general proposals set forth in the study or for financing such development; it did not adequately assess the risks or probabilities of success of each proposal; it was not written in a sufficiently comprehensible fashion; and it failed to provide the trustees with sufficient analysis and grounds for making informed decisions. The expert also testified that approximately $50,000 to $100,000 would have to be expended to raise the Schwartz study up to the level of a professionally competent document.

Similarly, no merit exists to appellants' claim that the Secretary's expert had the benefit of hindsight when critiquing the Schwartz study. The expert's testimony established the losses suffered by the Pension Fund as a result of the imprudent manner of selecting a consultant.

Had the individual appellants followed the prevailing procedure of withholding some of the fee until a satisfactory study was completed, they could have insisted on an upgraded study before disbursing to Dr. Schwartz the balance due. They were unable to do so, because they paid Dr. Schwartz the entire $250,000 in one lump sum several months before he submitted his study. Appellants have not shown that the district court's finding regarding the actual value of Dr. Schwartz's feasibility study was clearly erroneous.

## APPROPRIATENESS OF THE REMEDY

In addition to ordering restitution for the losses the Pension Fund suffered as a result of the below-market-interest rate on the $1½ million loan and the excess compensation for the feasibility study, the district court found the Pension Fund trustees jointly and severally liable for potential losses in connection with the $1½ million loan to the Convalescent Fund and the $650,000 loan to the S & F Spas. To insure the Pension Fund against such potential losses, the district court ordered the individual appellants to post a $1 million cash or corporate surety bond which is to remain in effect "until the outstanding balance on loans between the Pension Fund and S & F Spas is less than $2.25 million, until the outstanding balance on loans between the Pension Fund and the Convalescent Fund is less than $4.9 million, and until neither the Convalescent Fund nor S & F Spas is in default on any obligation owed to the Pension Fund." The district court also ordered the appointment of an investment manager to manage the Pension Fund's assets for a term of ten years. Appellants challenge both the bond requirement and the appointment of an investment manager.

Where there has been a breach of fiduciary duty, ERISA grants to the courts broad authority to fashion remedies for redressing the interests of participants and beneficiaries. *Eaves v. Penn*, 587 F.2d at 462; *Marshall v Snyder*, 572 F.2d 894, 901 (2d Cir. 1978). ERISA, 29 U.S.C. § 1109, specifically provides that:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

In effectuating this provision, Congress intended the courts to draw on principles of traditional trust law. *Eaves v. Penn*, 587 F.2d at 462. "Traditional trust law provides for broad and flexible remedies in cases involving breaches of fiduciary duty." *Id.* Courts also have a duty "to enforce the remedy which is most advantageous to the participants and most conducive to effectuating the purposes of the trust." *Id.; accord Marshall v. Glass/Metal Ass'n.*, 507 F. Supp. at 385; *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 643 (W.D. Wis. 1979).

Appellants' challenge to the $1 million bond requirement is that common law precludes courts from surcharging them for a breach of trust where no loss results to the trust. Contrary to appellants' assertion, the $1 million bond is not a surcharge. The bond is a security to protect the Pension Fund in the event of losses from the two loans the

district court found to be risky and inadequately secured. This remedy is consistent with common law remedies. At common law "[i]f breaches of trust have been committed, or are threatened, the court may order the giving of a bond to secure faithful performance in the future, or may increase the amount of the existing bond, or may require new sureties." G. Bogert, *The Law of Trusts and Trustees* § 861, at 11-12 (1982) (footnote omitted).[6] Proof of loss is not a prerequisite to imposing a bonding requirement. The purpose of imposing a bond in cases such as the present is not to compensate for past losses, rather it is to safeguard the beneficiaries' interests and to protect the fund against future losses.

Based on the district court's extensive findings regarding the ERISA violations and the common law of trust, we conclude that the district court properly exercised its broad discretion under § 1109 in requiring appellants to post a $1 million bond.[7]

Alternatively, appellants argue that the judgment should be modified by striking the language in the bonding requirement which provides that the bond be continued "until neither the Convalescent Fund nor S & F Spas is in default

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[6]In a footnote to this section Bogert notes that, under § 7-304 of the Uniform Probate Code, a court may require the trustee to file a bond if the court deems it "to be necessary to protect the interest of the beneficiaries." Bogert, *Trusts and Trustees* § 861, at 11-12 n.26.

[7]Contrary to appellants' claim, the district court in imposing the bond did not indulge in a presumption of guilt. The district court ordered the bond after it made extensive findings of fact and concluded that the Pension Fund trustees had committed numerous fiduciary breaches under ERISA.

on any obligation owed to the Pension Fund." Appellants contend that the effect of this language is to hold them liable for antecedent loans which are not part of the present litigation. We find their argument unpersuasive.

In its conclusions of law, the district court explicitly stated that the bond was to insure the Pension Fund against all losses stemming from the $1½ million Convalescent Fund loan and the $650,000 S & F Spas loan. We find that the district court inserted the challenged language to prevent the individual appellants from eliminating the bond requirement by nominally "paying off" the loans for which the bond is required by adding their outstanding balance to loans not covered by the bond. We see no valid reason to alter the district court's carefully drafted judgment.

## INVESTMENT MANAGER

The district court appointed an investment manager to assume control over the assets of the Pension Fund for ten years because it found that such a remedy was necessary to protect the Pension Fund as well as the interests of the beneficiaries and participants. In fashioning this remedy the district court explained:

> One consideration warranting this remedy is the making of the loans (and subsequent extensions and moratorium) between the Convalescent Fund and the Pension Fund by an interlocking set of trustees. A conflict of interest situation exists because these same people are on both sides of the transaction as borrower and lender. Even when the Convalescent Fund has a sole trustee, the trustees of the Pension Fund continue to act as his Advisory Committee. . . . A position of divided loyalties has arisen which is inconsistent with the independent and undivided loyalty to which the

> Pension Fund is entitled. Further facts supporting indeed, requiring appointment of an investment administrator include the lack of diversification of the Pension Fund portfolio, the trustees' failure properly to underwrite loans, their failure to secure the most advantageous interest rates, as well as their failure properly to investigate and evaluate the circumstances surrounding Dr. Schwartz's fee demand and his feasi- failure [sic] on the part of the trustees properly to acquit their fiduciary responsibilities in the management of Fund assets—a pattern which the evidence shows will continue absent effective remedial measures. Therefore, it is necessary to order immediate and continuing supervision of Pension Fund investment and financial activities by a competent, impartial and independent administrator or administrators.

The district court was careful to note that this remedy was limited to divesting them of their investment functions as trustees of the Pension Fund. In all other respects, they could continue to perform their duties.

Appellants argue however that the district court abused its discretion by appointing an investment manager because (1) the main reason for appointing the manager was the interfund transactions which the district court erroneously concluded were prohibited by § 1106(b)(2) of ERISA; (2) such relief is inappropriate unless the Pension Fund incurs losses or there is proof of dishonesty or self-dealing or there exist violations more serious than lack of diversification; (3) the beneficiaries of the Pension Fund were not given notice of the appointment of an investment manager, and (4) any investment manager selected by the court will be inappropriate because he or she will favor stock market investments rather than investments generat-

ing employment for union members. We reject each of appellants' arguments.

The record below clearly refutes appellants' contention that the district court's "main reason" for appointing the investment manager was the interfund transactions between the individual appellants as trustees of both the Pension Fund and Convalescent Fund. As noted above, the district court enumerated several independent grounds that mandated appointing an investment manager in this case.

Moreover, the district court did not err in finding a § 1106(b)(2) violation. In the joint pretrial statement, appellants stipulated as follows:

> At all times from January 1, 1975 to the present:
>
> (a) some participants of the Pension Fund have not been participants of the Convalescent Fund;
>
> (b) some participants of the Convalescent Fund have not been participants of the Pension Fund;
>
> (c) there have been a greater number of participants in the Convalescent Fund than in the Pension Fund; and
>
> (d) some contributing employers of the Pension Fund have not at the same time been contributing employers of the Convalescent Fund.

When appellants became aware that this stipulation could establish a per se violation of their fiduciary duty of undivided loyalty, they sought to relieve themselves of it. After an extended hearing the district court found that appellants were bound by the stipulation. They now contend that the district court committed prejudicial error by refusing to allow proof of the "substantial identity" of the Pension Fund and Convalescent Fund members. Even if

the district court had allowed such evidence, it would not have aided appellants.

In *Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979) the Third Circuit held that, subject to the Secretary's authority to grant an exemption under § 1108(a)[8] § 1106(b)(2) creates a per se prohibition against a loan between two funds where the trustees are identical but the participants and beneficiaries are not. *Id.* at 529, *cited with approval* in *M & R Inv. Co., Inc. v. Fitzsimmons*, 685 F.2d 283, 287 (9th Cir. 1982).

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[8]Section 1108(a) provides:

> The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any fiduciary or transactions, or class of fiduciaries or transactions, from all or part or the restrictions imposed by sections 1106 and 1107(a) of this title. Action under this subsection may be taken only after consultation and coordination with the Secretary of the Treasury. An exemption granted under this section shall not relieve a fiduciary from any other applicable provision of this Act. The Secretary may not grant an exemption under this subsection unless he finds that such exemption is—
>
> (1) administratively feasible,
>
> (2) in the interests of the plan and of its participants and beneficiaries, and
>
> (3) protective of the rights of participants and beneficiaries of such plan.
>
> Before granting an exemption under this subsection from section 1106(a) or 1107(a) of this title, the Secretary shall publish notice in the Federal Register of the pendency of the exemption, shall require that adequate notice be given to interested persons, and shall afford interested persons opportunity to present views. The Secretary may not grant an exemption under this subsection from section 1106(b) of this title unless he affords an opportunity for a hearing and makes a determination on the record with respect to the findings required by paragraphs (1), (2), and (3) of this subsection.

In *Cutaiar*, the court elaborated on the blanket prohibition of § 1106(b)(2) as follows:

> Fiduciaries acting on both sides of a loan transaction cannot negotiate the *best* terms for either plan. By balancing the interests of each plan, they may be able to construct terms which are fair and equitable for both plans; if so, they may qualify for a [§ 29 U.S.C. § 1108] exemption. But without the formal procedures required under § 1108, each plan deserves more than a balancing of interests. Each plan must be represented by trustees who are free to exert the maximum economic power manifested by their fund whenever they are negotiating a commercial transaction. Section [1106(b)(2)] speaks of "the interests of the plan or the interests of its participants or beneficiaries." *It does not speak of "some" or "many" or "most" of the participants. If there is a single member who participates in only one of the plans, his plan must be administered without regard for the interests of any other plan.* 590 F.2d at 530 (emphasis added).

We agree with the Third Circuit that this per se prohibition is consistent with the remedial purposes of ERISA, for "[a]t the heart of the fiduciary relationship is the duty of complete and undivided loyalty to the beneficiaries of the trust." *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. at 639. (W. Wisc. 1979).

In the case before us the individual appellants never offered to show that the members of both the Pension Fund and Convalescent Fund were identical. Thus, they were not prejudiced by the district court's refusal to allow evidence of "substantial identity" between the two funds. Therefore, the district court properly found that the individual appellants violated § 1106(b)(2) by granting the $1½ million

loan to the Convalescent Fund as well as the extension and the moratorium on debts owed to the Pension Fund.

We also reject appellants' contention that the ERISA violations found by the district court are insufficient to support the appointment of an investment manager. The Pension Fund in fact incurred substantial losses as a result of the below-market-interest-rate charged to the Convalescent Fund and the overpayment to Dr. Schwartz. The record evinces numerous other ERISA violations that clearly support the remedy fashioned by the district court. Appellants failed: (1) to underwrite properly the $1½ million loan to the Convalescent Fund and the $650,000 loan to S & F Spas; (2) to require additional security or consideration in exchange for the extension or moratorium on monies owed to it; (3) to diversify its investments; (4) to use accepted procedures in hiring Dr. Schwartz to perform the feasibility study; and (5) to act for the exclusive benefit of the Pension Fund's beneficiaries and participants by acting on both sides of the interfund transactions. The district court found that ERISA violations would continue unless the individual appellants ceased to control the Pension Fund's investment assets.

At common law, a court could completely remove a trustee if the court found that continuation as a trustee would harm the beneficiary's interests. II *Scott on Trusts* § 107, at 841. Under the broad remedial provision of ERISA courts have also found removal of fiduciaries to be an appropriate remedy upon findings of imprudence, divided loyalties, and prohibited transactions. *See, e.g., Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629; *Marshall v. Kelly*, 465 F. Supp. 341 (W.D. Okla. 1978).

Thus, in the present case where the trustees committed numerous ERISA violations, the district court acted well within its broad discretion in divesting the individual appellants of their investment functions as trustees of the Pension Fund.

Appellants also challenge the appointment of an investment manager because the district court did not give the beneficiaries of the Pension Fund an opportunity to object. Appellants' reliance on Fed. R. Civ. P. 23 in support of this contention is misplaced because Rule 23 applies to class action suits.

Although at common law beneficiaries' desires were considered in appointing new trustees, in interpreting the fiduciary provisions of ERISA Congress cautioned courts not to rely exclusively on the common law. *See Marshall v. Teamsters Local 282 Pension Trust Fund,* 458 F. Supp. at 990. A court should consider the "special nature, purpose, and importance of modern employee benefit plans." *Marshall v. Glass/Metal Ass'n.,* 507 F. Supp. at 383. Indeed, Congress has indicated that certain elements of conventional trust law should not be incorporated into ERISA's fiduciary provisions. As an example Congress cited the common law rule of carrying out a settlor's intent even if it permitted deviations from applicable fiduciary requirements. *See, e.g.,* S. Rep. No. 93-127, 93d Cong., 1st Sess., reprinted in 1974 U.S. Code Cong. & Ad. News 4838, 4865. In light of the legislative history and the explicit language of § 1109, we agree with the Secretary that Congress did not intend to require that beneficiaries be given notice and an opportunity to object before a court-ordered change in the management of a plan is instituted. To hold

otherwise might eviscerate the explicit power Congress gave courts to remove fiduciaries. Furthermore, the procedural quagmire which could result if such a requirement were imposed militates against imposing a notice requirement.

Finally, appellants assert that the new investment manager is inappropriate because he or she will favor stock market investments as opposed to those generating employment for union members. Nothing in the record, however, suggests that a court-appointed investment manager will make investments in a manner inconsistent with ERISA.

## CONTEMPT

In the second appeal appellants challenge the district court's September 30 order finding the individual appellants in contempt and imposing $100 daily fines per trustee for failing to post the $1 million bond by September 7, 1982. The sole issue before us is whether the district court abused its discretion in holding the individual appellants in contempt. *See United States v. Powers*, 629 F.2d 619, 624 (9th Cir. 1980); *accord V.T.A. Inc. v. Airco, Inc.*, 597 F.2d 220, 226 (10th Cir. 1979). We find no issue of abuse of discretion.[9]

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[9]Appellants assert that the bond requirement was an order to pay money and, therefore, a writ of execution instead of contempt, was the appropriate method to enforce the judgment. We find appellants' argument unpersuasive. The judgment ordering the posting of a bond is an order to post security, not an order to pay money. Even if the bond requirement was deemed to be an order to pay money just as an equitable decree of restitution ordering the payment of money may be enforced through a contempt action, *see, e.g., McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 193-94 (1949) *Tobin v. La Duke*, 190 F.2d 677, 678 (9th Cir. 1951); *Usery v. Fisher*, 565 F.2d 137, 139-40 (10th Cir. 1977), so may an order

Absent a stay, "all orders and judgments of courts must be complied with promptly." *Maness v. Meyers,* 419 U.S. 449, 458 (1975). In the present case the bond requirement was not stayed. The record clearly demonstrates that the Secretary established a prima facie case that the individual appellants failed to comply with the district court's order requiring them to post the bond by September 7. *See United States v. Rylander,* 656 F.2d 1313, 1318 (9th Cir. 1981), rev'd on other grounds 103 S.Ct. 1548 (1983). The individual appellants then bore the burden of demonstrating that they were unable to comply. *See id.*[10] To satisfy this burden the individual appellants were required to show "categorically and in detail" why they were unable to

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requiring a party to post a bond. In *Usery,* the Tenth Circuit specificially held that a court could not require the government to resort to execution or garnishment before making available its contempt power. 565 F.2d at 140.

The cases relied on by appellants in support of their argument were decided prior to *McComb, Tobin* and *Usery.* We agree with the Secretary that these latter cases present the better view.

Moreover, orders to remedy breaches of fiduciary duty, that mandate payment of money as restitution are equitable in nature. *See, e.g., Local No. 92, Int'l Ass'n of Bridge Workers v. Norris,* 383 F.2d 735, 741 (5th Cir. 1967); III *Scott on Trusts* § 199.3, at 1639-40. In enacting ERISA Congress intended to provide courts with the broad and flexible equitable remedies of traditional trust law in cases involving breaches of fiduciary duty. *See Eaves v. Penn,* 587 F.2d at 462. Thus, in light of *McComb* and its progeny and the legislative history of ERISA, an order to pay money under ERISA is enforceable through contempt.

[10]Appellants rely on *Maggio v. Zeitz,* 333 U.S. 56, 72-78 (1948) for the proposition that the Secretary bore the initial burden of showing their ability to comply with the district court's order. Their reliance on *Maggio* is misplaced. *Maggio* is consistent with the burden of proof allocation enunciated in *Rylander. See Maggio,* 333 U.S. at 75-76.

comply with the court's previous order. *See id.* They failed to satisfy this burden. Indeed, at the contempt hearing the individual appellants admitted, through their counsel, that collectively they had sufficient assets to post the bond. On appeal they admit that they "tended not to come to grips with the reality of having to raise $1 million while there was still some hope that the court might ease the requirements or even eliminate it" and that they put off posting the bond during post-trial negotiations. Appellants' assertions of their good faith efforts to comply with the order are irrelevant. Intent is not an issue in civil contempt proceedings. *McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 191 (1949); *accord Jim Walter Resources, Inc. v. International Union, UMW*, 609 F.2d 165, 168 (5th Cir. 1980). The sole question is whether a party complied with the district court's order. *See McComb*, 336 U.S. at 191; *Jim Walter Resources*, 609 F.2d at 169. Appellants did not. They also failed to present a cognizable defense. In these circumstances a finding of contempt was within the district court's discretion.

We also reject appellants' contention that the district court abused its discretion by denying their motion for a continuance to allow the trustees to introduce their depositions regarding their financial condition. The record demonstrates that at the September 30 hearing the district court was willing to hear any testimony regarding the trustees' ability or inability to post the bond. Appellants failed to proffer any evidence relevant to that issue. The only evidence proffered was the testimony of Frank Sullivan, administrator of the union trust funds. Mr. Sullivan admitted that he knew nothing about the individual appel-

lants' financial conditions. Appellants had ample notice that they had to show cause on September 30, 1982. On that date they failed to present any evidence relevant to the issue of their inability to post the bond. Their ignorance as to the burden of proof does not excuse them from having to show cause on that date. Thus, the district court did not abuse its discretion in denying the request for a continuance. Moreover, the district court allowed the trustees until November 2, 1982 to purge themselves of contempt by posting the bond.

The district court judgments are AFFIRMED.

## Appendix B

In the United States District Court
For the Northern District of California

No. C-79-134 SAW

Raymond J. Donovan,
Plaintiff,

vs.

Joseph P. Mazzola, et al.,
Defendants.

[Filed Nov. 17, 1981]

FINDINGS OF FACT; CONCLUSIONS OF LAW

This matter is before the Court on cross-objections to the recommendation of Magistrate Frederick J. Woelflen. *See* L.R. 410-2(b). The Court has considered the parties' objections and made a *de novo* determination of all portions of the Magistrate's recommendation to which either side objected. *See Coolidge v. Schooner California,* 637 F.2d 1321 (9th Cir. 1981); L.R. 410-2(b). Defendants requested the Court to consider certain deposition testimony which had been excluded from the record by the Magistrate. The Magistrate properly excluded deposition testimony by witnesses who also testified at trial. *See* Fed. R. Civ. P. 32(a)(3). Nevertheless, in order to assure itself that no relevant testimony was ignored, the Court reviewed all deposition testimony cited by defendants in their objections to the Magistrate's proposed findings and conclusions. The deposition testimony was for the most part irrelevant or im-

material. None of the deposition testimony cited required any change in the Magistrate's proposed findings and conclusions.

Accordingly, after careful, complete and detailed review, this Court enters the following findings of fact and conclusions of law as its decision in this case.

## FINDINGS OF FACT

1. This action arises under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001, *et seq.* It is brought by the Secretary of Labor to enjoin acts and practices which allegedly violate certain provisions of Title 1 of ERISA.

2. This Court has jurisdiction pursuant to ERISA, 29 U.S.C. § 1132(e)(1).

3. Venue lies in the United States District Court for the Northern District of California pursuant to ERISA, 29 U.S.C. § 1132(e)(2).

4. The evidence in the record concerns three basic subjects: (1) loans and extension of credit from assets of the Local 38 Pension Fund made by the defendant trustees to the Local 38 Convalescent Fund; (2) loans from the Pension Fund to S&F Spas, Limited Partnership (S&F); and (3) payment of $250,000 in Pension Fund assets to Dr. Ernest Schwartz, for his performance of a feasibility study regarding use and development of realty owned by the Convalescent Fund, located at Clear Lake, California.

## I. TRANSACTIONS BETWEEN THE PENSION FUND AND CONVALESCENT FUND

A. *Background:* The Funds and the Trustees

5. Local Union 38 of the United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry is a labor union operating in, and with members primarily working in, the Northern California area. The Local 38 Pension Fund was established in 1953 by trustors representing the Union and other trustors representing employers who employ members of the Union. The Pension Fund was created to provide retirement benefits to participants and beneficiaries of the Fund.

6. Local 38 is signatory to various collective bargaining agreements with employers of members of the Union (signatory employers).

7. The Local 38 Pension Fund is an Employee Benefit Plan, within the meaning of ERISA, 29 U.S.C. § 1002(3), and thus subject to the coverage of ERISA, 29 U.S.C. § 1003(a).

8. Defendants, by virtue of their actions and authorities as trustees of the Pension Plan, are fiduciaries with respect to the Plan pursuant to ERISA, 29 U.S.C. § 1002(21)(A).

9. The Local 38 Convalescent Fund similarly was established in 1956 by trustors representing the Union and signatory employers. At all times from January 1, 1975, to the present: (a) some participants of the Pension Fund have not been participants of the Convalescent Fund; (b) some participants of the Convalescent Fund have not been participants of the Pension Fund; (c) there have been a greater number of participants in the Convalescent Fund

than in the Pension Fund; (d) some contributing employers of the Pension Fund have not at the same time been contributing employers of the Convalescent Fund; and (e) the eligibility requirements of the two Funds have differed.

10. The Convalescent Fund owns and runs a hotel at Clear Lake called the Konocti Harbor Inn, a summer camp for children and a low cost retirement housing project (Lakeside Haven). One of the Fund's benefits is the opportunity under certain circumstances for participants of the Fund and their families to rent rooms at Konocti Harbor Inn at discounted rates. These discounts benefited participants in the Convalescent Fund but were of dubious benefit, if any, to the Pension Fund. The property at Clear Lake is also utilized in part of provide a summer camp for children of eligible Convalescent Fund participants.

11. Over the years the total amount of the discounts given to participants in the Convalescent Fund does not account for the large losses sustained by the Inn. That total amount of discounts was $61,409 in 1973; $77,551 in 1974; $81,792 in 1975; and $24,200 in the first 11 months of 1976 (with the December discounts usually being negligible). The Fund has not kept similar statistics for years after 1976. The Inn has suffered operating losses of approximately $1.58 million in 1975; $1.78 million in 1976; and $1.82 million in 1977.

12. Another benefit provided by the Convalescent Fund is the availability of low-cost retirement housing for certain participants. This benefit is made available by financing a nonprofit corporation called Lakeside Haven. The Cost to the Convalescent Fund of financing Lakeside Haven exceeded the benefits. The Fund's contribution to

Lakeside Haven was $131,634 in 1974; $106,965 in 1975; $173,227 in 1976; and $204,437 in 1977. During those years, however, no more than 12 retirees and their families occupied housing at Lakeside Haven at any time.

13. Despite the fact that the Convalescent Fund has for years provided for a low level of benefits at a very high cost, none of the trustees or other representatives of that Fund has ever determined the cost or feasibility of providing the various benefits outlined above by some means other than direct ownership of the Inn, camp and retirement housing by the Fund and Lakeside Haven. The trustees, by the terms of the collective bargaining agreement, have unlimited discretion as to the acquisition, retention or disposition of the Convalescent Fund properties. Funds utilized for investment in and maintenance of the Clear Lake property could have been available for use in another form of benefit.

14. The individual defendants herein are the trustees of the Pension Fund. From January 1, 1975, until approximately November 30, 1978, the same persons who served as trustees of the Pension Fund also served as trustees of the Convalescent Fund. From November 30, 1978, to the present, the same persons who served as trustees for the Pension Fund supposedly acted as an "Advisory Committee" to a sole trustee of the Convalescent Fund. For a period of time after the death of the first sole trustee, Mr. William Dwyer served, de facto, as sole trustee of the Convalescent Fund, although he never formally accepted the position. M. M. Smith is presently serving as sole trustee of the Convalescent Fund.

B. *The $1.5 Million Loan*

The Making of the Loan

15. As of January 1, 1975, the defendant trustees had already loaned to the Convalescent Fund $5.5 million of Pension Fund money. Those loans consisted of a $5 million consolidated loan, made in 1972, at 8%, and a $500,000 loan made in December 1974, with a floating rate between 8½-10%, tied to the prime rate. In December 1975—nearly a year after the fiduciary responsibility provisions of ERISA came into effect—the defendant trustees, in their capacity as trustees of the Convalescent Fund, sought a $1.5 million loan from the Pension Fund, and as trustees of the Pension Fund, granted that loan. As explained in detail below, and as the Court finds, the record demonstrates that in making this loan, the Pension Fund trustees: (1) subjected that Fund to an unreasonable risk that the borrower could not continue timely and full loan repayment, because of its poor financial condition, and (2) failed to ascertain the value of the underlying security for the loan so that collection, in the event of foreclosure, was uncertain.

16. The Convalescent Fund's poor financial condition—and thus the risk that it could not repay the Pension Fund on the $1.5 million loan—is highlighted by a number of facts.[1] First, as of December 1975, the Konocti property

[1]The Court relies only on those facts relating to the period before the loan was granted in determining that the loan was too risky when made. The facts relating to the Convalescent Fund's condition subsequent to December 1975, are, however, relevant to the Court's further findings concerning the trustees' imprudence in failing to exact additional concessions when granting the Convalescent Fund a moratorium and two extensions.

had for years been a losing proposition. The Convalescent Fund's single largest and only income-producing asset—Konocti Harbor Inn—has lost more than $1 million annually in every year since 1973 (and nearly $2 million in 1976 and 1977). More significantly, operating losses exclusive of interest and depreciation, have exceeded one-half million dollars per year from 1973 to 1978; operating losses in 1979 exceeded $350,000. As a result, the Convalescent Fund depended heavily on collective bargaining contributions, infusions from other Local 38 plans, and outside financing, in order to continue meeting its debt service payments.

17. Contributions from signatory employers, which have provided substantial monies to the Convalescent Fund, did not assure that Fund's ability to make good on its loan obligations because of the contingent character of the contributions. First, the contributions to all Local 38 Funds are subject to reallocation among the Funds by the Joint Industry Board. Second, the contributions are contingent because amounts are geared to the number of hours worked by covered employees. From the mid-1970's up to and including 1976, the total number of hours worked declined because of a general slump in the construction industry, and thus the amount of contributions likewise declined between 1973 and 1976, with an upward trend in 1978. Finally, contributions paid indirectly through the Health and Welfare Fund are available only if that Fund does not use the money to pay benefits.

18. After taking into account the employer contributions and other transfers to the Convalescent Fund, the Fund's financial statements show that current assets have

fallen far short of current liabilities every year since 1974. In 1974, the ratio of current assets to current liabilities was approximately 1 to 2; in 1975, 1 to 4; in 1976, 1 to 4; in 1977, 1 to 8 and in 1978, 1 to 8. Moreover, from 1973 to the present, the Convalescent Fund has experienced a generally unfavorable cash flow. Working capital has decreased every year since 1974. Notwithstanding the employer contributions, the Convalescent Fund's yearly expenses have exceeded its revenues for every year since 1973, and the Fund's balance has steadily declined from approximately $1.5 million in 1973 to a deficit of approximately $1,158,000 in 1979. The poor financial condition of the Convalescent Fund is highlighted by the fact that the Fund's financial statements are qualified, *i.e.*, issued with qualifications by the accountant.

19. As further indicia of the poor financial condition of the Convalescent Fund, the parties have stipulated that shortly before the $1.5 million loan was made, that Fund owed Crocker Bank approximately $1.3 million on loans from the Bank, and the Fund had in 1974 missed four monthly payments on that debt. At the time the Pension Fund approved the $1.5 million loan to the Convalescent Fund, it had failed to make its last two payments on the earlier $5 million Pension Fund loan.

20. The evidence shows that the defendants failed to ascertain the value of the security for the $1.5 million loan. The security given on that loan was essentially the same as given on the earlier 1972 loan of $5 million, *i.e.*, deeds of trust on the Clear Lake property owned by the Convalescent Fund. A portion of the acreage covered by those deeds of trust was subject to prior liens given by the Convales-

cent Fund to Crocker Bank in return for loans by Crocker. The value of the property on which the Pension Fund's interest is subordinate to that of Crocker Bank had not been ascertained by defendants.

21. According to a 1975 appraisal by Edward Morphy (one of defendants' expert witnesses), the value of the totality of the Convalescent Fund's property was approximately $16 million. However, the security given to the Pension Fund on the $1.5 million note, comprised not only *part* of the property appraised, and that separate part had never been appraised to determine its value apart from the whole. Moreover, the property which does *not* secure the Pension Fund's loans contains the Konocti Harbor Inn Clubhouse and other facilities which account for a large portion of the entire property's value. In addition, part of the security for this loan was subject to prior rights held by Crocker Bank. Thus the value of the entire security was uncertain.

22. The expert testimony of Joseph Azrack was introduced by plaintiff to establish the prevailing standards and practices applied by competent real estate lenders in making, pricing and managing real estate secured loans. Based on the record in this case, Mr. Azrack also testified that the conduct of the defendant trustees regarding the transactions at issue did not meet industry standards. Mr. Azrack's testimony, in the main, was unchallenged, except for the contention by defendants that the Pension Fund investment portfolio was adequately and sufficiently diversified. The Court finds that in granting and funding the $1.5 million loan to the Convalescent Fund, the trustees, on behalf of the Pension Fund, did not act in accordance

with accepted and prudent standards exercised by reasonably competent lenders of funds secured by real estate. Mr. Azrack testified to the following deficiences in the way the trustees approved the $1.5 million loan: (1) prior to making the loan, the trustees did not ascertain the value of the collateral based upon a reliable appraisal. A prior appraisal of a larger parcel of realty than that which secured the loan was not a reliable indication of the value of the realty put up as collateral. (2) No consideration was given in the appraisal relied upon by the trustees (the Morphy Appraisal) to the actual debt service coverage ratio. This figure represents the ratio of the property's net operating income to the total debt service payments on the secured property. The appraisal was also unreliable because it was based on an unsupported and erroneous estimate of $980,000 potential operating income for Konocti Harbor Inn, the Convalescent Fund's principal asset, in the face of the fact that the Inn's actual operations showed a deficit of over a half million dollars a year. Plaintiff's expert further testified that a reasonably competent real estate lender would not have made the $1.5 million loan because at that instance, the financial condition of the borrower, the Convalescent Fund, was so weak that the loan presented an unreasonable risk of nonpayment.

23. Mr. Azrack testified that the interest rates on long-term commercial mortgages in or about December of 1975 ranged from 9.75% to 10%—over one percent more than the 8.5% rate on the $1.5 million loan. Even if California law purporting to limit the interest rate to 10% was applicable to loan and security transactions arising out of ERISA, the interest rate allowed by the defendants was unjustifiably low.

C. *The Moratorium*

The Granting of the Moratorium in 1976

24. Following the granting of the $1.5 million loan, the defendant trustees extended additional credit to the Convalescent Fund. In October 1976, the defendants, in their capacity as trustees for the Convalescent Fund, sought from the Pension Fund a moratorium on repayment of *all* outstanding loans from the lender—Pension Fund. These same defendants, as trustees of the lender, contemporaneously granted a six month moratorium.

25. Prior to and at the time the loan moratorium was granted, there had been a decrease in the contributions (direct and indirect) by the employees to the Convalescent Fund. This reduction in the Convalescent Fund's revenue was occasioned by a cutback in the activities of the construction industry in the counties over which Local 38 had jurisdiction. The lessening of this source of revenue had a direct effect on the Convalescent Fund's ability to meet and pay its loan obligations. The Convalescent Fund's inability to pay its loan obligations was a reason for the request for a moratorium on its loan obligations to the Pension Fund, although the Convalescent Fund did not seek such relief from Crocker Bank, upon a loan that had priority over the Pension Fund Loans.

26. Expert evidence produced at trial by plaintiff, which in the main was uncontroverted, established that a reasonably competent real estate lender, standing in a like position to the Pension Fund trustees at the time the moratorium was requested, would have granted a moratorium only upon receiving additional and further consideration from the borrower. Plaintiff's expert, Mr. Azrack, testified

that ordinarily, as a condition for granting such a moratorium, the lender demands either (1) an accelerated repayment schedule following the moratorium period to reduce the risk the loan will not be paid; (2) higher interest rates; (3) additional security; or (4) some combination of the above. In the case of the Pension Fund trustees, nothing of consequence was demanded or requested of the Convalescent Fund in return for granting the six month moratorium. The terms of the moratorium, as granted, provided that all interest and principal payments otherwise due during the six month period, would be added to the final payment on the loans. The Pension Fund trustees, in allowing the moratorium, failed to seek or demand, in accordance with accepted and competent real estate lending practices, (1) any additional security for any of the loans; (2) any change in the terms of the notes; or (3) any increase in the interest rates on any of the Convalescent Fund notes which would have resulted in additional security and/or income for the lender Pension Fund. At the time the moratorium was granted, no real estate secured the $500,000 loan and not all of the Convalescent Fund real estate secured the $5 million and $1.5 million loans. Further, at the time the moratorium was granted, interest rates on similar real estate loans carried a higher percentage than the interest rates on the $1.5 million, $500,000 and $5 million loans. It was not good, competent or reasonable business practice to extend a moratorium on the outstanding loans without receipt of additional security or consideration in light of the fact that the individual defendants were acting in the dual capacity of trustees for the requesting Convalescent Fund (the borrower) and trustees for the granting Pension Fund (the lender).

D. *The Extensions*

27. In 1978 and 1979, the defendant trustees granted two extensions on the due dates of the $500,000 loan referred to in Finding 14. The extensions, granted on or about November 30, 1978, and on July 25, 1979, extended the original due date of November 1, 1978, for the final payment due on the loan. The amount owed on the final payment was in excess of $400,000. These extensions are relevant to the trustees' competence and prudence in exercising their business responsibilities. Viewed in isolation, the extensions are not sufficient to grant the relief sought by the Secretary. However, evaluated with the other loan activities of the Pension Fund trustees, the extensions support the ultimate findings in this case. The first extension was requested by the sole trustee of the Convalescent Fund after the defendant trustees, acting in their capacity as his "Advisory Committee", advised him to request it. These same defendants then granted his request, acting as the trustees of the Pension Fund. The second extension was requested directly by the "Advisory Committee", in the absence of a newly appointed sole trustee. The same individuals, in their capacity as trustees of the Pension Fund, then granted the second extension.

28. The Pension Fund trustees granted the extensions without seeking or receiving any additional security or consideration from the Convalescent Fund. The security for the loan is an assignment to the Pension Fund of (1) contributions not used by the Local 38 Health and Welfare Fund, that would otherwise be transferred to the Convalescent Fund; and (2) employer contributions to the Convalescent Fund, made pursuant to collective bargaining

agreements. The assignment has always been subject to a prior and senior assignment of the very same rights to Crocker Bank.

29. Plaintiff presented sufficient evidence to support its contention that these extensions were not granted in accordance with accepted and prudent lending procedures. Plaintiff's expert, Mr. Azrack testified that a reasonably competent real estate lender, under circumstances similar to the ones faced by the Pension Fund trustees, would not have granted the extensions without requiring some modification in the terms of the loans to protect the interests of the lender and compensate the Pension Fund for granting the extensions. Modifications ordinarily extracted as a condition to granting extensions include an accelerated repayment schedule, higher interest rates, additional security or some combination of the above. The Court finds that the Pension Fund trustees, having neither sought nor agreed upon further security or consideration for the extensions, did not conduct themselves in accordance with the accepted practices of reasonably competent real estate lenders.

## II. THE S&F LOANS

### A. *The S&F Partnership and S&F Property*

30. S&F is a limited partnership created on or about October 1, 1978, of which Dr. Ernest Schwartz is the sole general partner. John Ford is a limited partner of S&F.

31. The primary purpose and function of S&F has been, and continues to be, the development and promotion of a health spa facility in Santa Rosa, California. In early 1979, S&F purchased the property for $1.65 million. At the time

of acquisition, the property included a 104-room, 2-story hotel, kennel, swimming pool, tennis courts and a second building which housed a reception area, administrative offices, several meeting rooms, a dining room, a bar and cocktail lounge, a banquet room and a kitchen.

32. In order to operate the physical plant as a health spa, it was necessary for S&F to convert the hotel into a recreation and exercise facility. Until at least March 20, 1980, the sole business activity of S&F has been in connection with the Santa Rosa property. S&F has never had an equitable or legal interest in any other property.

33. The Santa Rosa health spa operates under an association with Weight Watchers and is the first of its type in the United States.

B. *Underwriting the $2.25 Million Loan*

34. Funds were required by S&F to convert the Santa Rosa property from a conventional hotel into a recreation and exercise facility. General partner Schwartz applied in November 1978, for a loan from the Pension Fund for development of the spa. On or about November 30, 1978, the Pension Fund trustees granted a $2.25 million construction loan, secured by the Santa Rosa property. The granting and funding of the $2.25 million loan is not itself an issue in this case. However, the loan is an issue to the extent it must be considered within the context of other loans underwritten and granted by the Pension Fund trustees. Plaintiff produced testimony at trial that the underwriting of the $2.25 million loan was not performed in accordance with accepted lending practices. The record discloses that the Pension Fund trustees committed and funded the loan with-

out first securing or reviewing basic documentation about the spa project, including certified financial statements of S&F or its general or limited partners, accurate cost figures, a complete market study, or architectural and engineering plans and specifications. The Pension Fund trustees paid the entire $2.25 million into escrow in February 1979. The proceeds of the loan were disbursed in a single lump sum: Approximately $1.6 million was applied to the balance owing on the purchase price of the Santa Rosa property and about $794,000 was paid out of escrow to S&F. Expert testimony by plaintiff established it was not customary or good lending practice in the case of construction loans to pay the amount of the loan in one lump sum. Plaintiff's expert testified that reasonably competent mortgage lenders, when underwriting real estate loans, make progressive and periodic payments as the construction goes forward.

C. *Underwriting the $650,000 Loan*

35. In April 1979, less than three months after the proceeds of the $2.25 million loan had been disbursed, Dr. Schwartz advised the Pension Fund trustees that additional funding was needed to complete the project. On or about June 18, 1979, the Pension Fund trustees made a loan of $650,000 to S&F.

36. In granting the original loan of $2.25 million and the subsequent loan of $650,000 to S&F, the Pension Fund trustees relied on the accuracy of the "Klatt Feasibility Study". The Klatt Feasibility Study was submitted to the Pension Fund trustees in October 1978. As of March 1980, neither the Klatt Feasibility Study nor the appraisal had been amended or updated.

37. Based upon expert testimony on behalf of plaintiff, the Court finds that the Klatt Feasibility Study would not have been accepted or acted upon by reasonably competent lenders under similar circumstances. The unreliability of the Klatt study is found in its serious underestimation of the cost of converting the Santa Rosa Hotel into a fully operational spa. The Klatt study estimated that cost at $386,000, plus the cost of acquiring the property for $1.65 million, for a total of approximately $2 million. As of November 1978, Dr. Schwartz estimated the total cost for completing the conversion was $1.35 million plus the $1.65 million acquisition cost for a total of $3 million, excluding costs for interior work and start-up expenses. In June 1979, Dr. Schwartz anticipated the acquisition and conversion cost, excluding interior work and start-up expenses in excess of $3 million. By March 1980, the estimation was approximately $3.5 million. The unreliability of the Klatt Feasibility Study stems, in part, from the fact that the study was prepared and submitted without any architectural drawings of the spa project. The Klatt study also underestimated the costs of landscaping the grounds and constructing the health spa building. The study assumed that the health spa building to be constructed would be 6,000 square feet, when, in fact, the building was 13,000 square feet. In addition, the study denominated work on the second building as "minor revision of the lounge and banquet room", when the actual construction has included enlargement of the dining room, alterations of the building's exterior and main entrance, elimination of the bar, of the cocktail room and of the entertainment stage as well as rearangement of other offices.

38. When application for the $650,000 loan was made in June 1979, basic information about the spa project which should have been required for use by the trustees in granting the $2.5 million loan was still unavailable. (*See* Stipulation re Interrogatory 9(g); Supplemental Stipulation re 9(g), filed October 22, 1980; Stipulation 236.) At the time the $650,000 loan was committed and disbursed, the Pension Fund trustees did not have any cost estimates for the construction of the spa, other than the Klatt Feasibility Study, nor any certified financial statements of S&F or any of its general or limited partners, nor any market analysis of the health spa project, other than the Klatt Feasibility Study and appraisal. Prior to making the $650,000 loan to S&F Spas, the Pension Fund trustees also failed to verify how S&F had utilized the proceeds of the $2.25 million loan. After disbursing the $650,000 loan in a lump sum, the trustees failed to implement any system for monitoring the use and application by S&F of the proceeds from the $2.25 million and $650,000 loans.

D. *Inadequacy of Security for the $650,000 Loan*

39. The $650,000 loan from the Pension Fund to S&F Spas was secured by:

(a) the interest of John Ford (a limited partner in S&F Spas) in five condominium units in Poinciana Manor;

(b) the interest of John Ford in one condominium unit in Wailana; and

(c) the interest of Ernest Schwartz in a $610,000 promissory note from Nelson Skalbania and Kalskal Holdings, Ltd.

40. Mr. Ford's total equity in the five Poinciana Manor units is presently $275,000. His equity in the Wailana unit is approximately $200,000. Part of his equity in these properties is the result of appreciation which occurred subsequent to the time the $650,000 loan was made. At the time of the loan, the value of Mr. Ford's interest in the real estate pledged as security for the $650,000 loan was in an amount less than $475,000.

41. Dr. Schwartz's interest in the $610,000 note was $500,000. The assignment of Dr. Schwartz's interest in the $610,000 note as security for the $650,000 loan is of uncertain validity. The terms of the agreement giving rise to the promissory note indicate the note could only be assigned with the written consent of Mr. Skalbania, the obligor under the note. No evidence was presented at trial that the obligor under the note authorized the assignment of the note as required by its terms. Furthermore, although the Skalbania note does not state the date on which it is due, testimony at trial established that it is payable in full to Dr. Schwartz no later than May 1, 1982. *See* R.T., Schwartz, Nov. 4, 1980, at 202. Because the final balloon payment on the $650,000 loan to S&F Spas is not due until sometime later, the Skalbania note could not adequately secure that final balloon payment. Therefore, the only valid security for the $650,000 loan was Mr. Ford's equity in his Hawaiian condominiums which amounted to something less than $475,000. This is insufficient to secure a $650,000 loan. The fact that Ernest Schwartz signed personally on the $650,000 note as a general partner, does not in and of itself render the security adequate so as to exculpate the defendants from granting this loan under circumstances which the Court finds to have been neither prudent nor reasonable.

E. *The Ability of S&F to Repay the Loans Without Resort to Foreclosure on the Security*

42. As of March 27, 1980, S&F had no source of income or financing other than (1) capital contributions from its partners; (2) loans from the Pension Fund; (3) extensions of credit of less than $25,000 from suppliers; and (4) income derived from the operation of the hotel on the Santa Rosa property. Dr. Schwartz does not know if any part of the $650,000 loan proceeds were used to make interest or principal payments on the $2.25 million loan. Dr. Schwartz has never informed the trustees that he and Mr. Ford made capital contributions to S&F in excess of the initial contributions, or of the amount of such contributions.

43. The only income S&F was entitled to receive from the operation of the spa was rental payments from its tenant, Seabarm, Inc. and that rental was insufficient for S&F to repay the Pension Fund. Seabarm, Inc., a corporation owned by Dr. Schwartz and his family, holds a licensing agreement with Weight Watchers, dated January 19, 1979, and has a contract with Weight Watchers to manage health spas built and operated in the United States. Pursuant to a lease entered into between Seabarm, Inc. and S&F on February 23, 1979 (the "1979 lease"), Seabarm was to operate and manage the health resort and was to receive all revenues generated by the spa. It should be noted here that had the trustees investigated further S&F's operation or relationship to the operation of the health resort, they would have determined that the income from the resort's operation was directed to the lessee, Seabarm, which had only an obligation to pay a fixed monthly rental fee to S&F.

44. As of March 27, 1980, the 1979 lease between S&F and Seabarm, Inc. was the only lease in effect between them. Under that lease, S&F was entitled to receive as rent from its lessee, Seabarm, a total of $240,000 per year. The total yearly amount of principal and interest payments that S&F owes the Pension Fund pursuant to the promissory notes associated with the $2.25 million loan and the $650,000 loan combined is approximately $300,000.

45. Neither the Pension Fund trustees, nor any representative of the Local 38 Funds, were aware, until approximately six months after granting the $650,000 loan, that the amount of rent S&F was entitled to receive under the 1979 lease agreement was less than the annual principal plus interest payments owed on the $2.25 million and $650,000 loans combined.

46. Although Seabarm was lessee of the spa, no evidence was presented that Seabarm was legally obligated to pay S&F's debt obligation to the Pension Fund.

47. After commencement of this litigation, S&F entered into a new lease which, by its terms, leases the new completed health spa to an entity known as Spa Services. The July 1, 1980, lease between Spa Services and S&F provides for a monthly rental to S&F that is substantially higher than that under the Seabarm-S&F lease. However, the S&F-Spa Services lease agreement is not pertinent to the issue of the Pension Fund trustees' prudence in making the $650,000 loan. In determining whether a reasonably competent real estate lender would have granted the $650,000 loan, the Court must look at the information the trustees possessed and the procedures they followed at the time the loan was committed and the funds disbursed. There is no

evidence in the record that at the time the $2.25 million loan and the $650,000 loan were entered into any of the trustees or their agents had reason to believe or the right to expect that a more favorable lease would be entered into by S&F. The Court finds that a reasonable inquiry conducted by the Pension Fund trustees, at the time the $650,000 loan was made, would have readily disclosed to the trustees that S&F's resources were not sufficient to meet the obligations of the loans made by the trustees.

F. *A Reasonably Competent Real Estate Lender Would Not Have Made the $650,000 Loan*

48. Plaintiff provided expert testimony, through Mr. Azrack, regarding the procedures followed and information collected by reasonably competent mortgage lenders when underwriting real estate loans. Having compared the quantity and quality of information which plaintiff's expert testified was necessary for the $650,000 loan to be adequately underwritten with the information obtained by trustees and Pension Fund agents, the Court finds that a reasonably competent real estate lender in the position of the trustees would not have made the $650,000 loan. The following findings support that over-all determination.

49. The $650,000 loan was inadequately underwritten in that adequate information about the loan's risks was not gathered and taken into account in shaping the terms and conditions of the loan. Prior to the committing and funding of such a loan, a reasonably competent real estate lender would have required, received and assessed the following information, none of which was obtained by the trustees or their agents: A property survey of the spa property; a reliable economic feasibility analysis of the

spa project; an appraisal of the spa project as completed; current certified financial statements from the borrower; a disbursement schedule providing for a hold-back on the final advance of loan proceeds; and a credit analysis of the major tenant of the spa project at the time of the loan.

50. Market, cost and descriptive information was provided to the Pension Fund trustees prior to the making of the $2.25 million and $650,000 loans to the extent it was contained in the Klatt Feasibility Study and appraisal. The Court finds, however, that the information contained in the Klatt study was outdated, inaccurate and unreliable by the time the $650,000 loan was committed, and that, indeed, the need for the loan itself gave defendants notice of that fact. Under these circumstances, a reasonably competent real estate lender acting for the Pension Fund would have demanded updated information prior to making the loan.

51. A reasonably competent real estate lender acting for the Pension Fund would have determined how the proceeds of the $2.25 million had been used prior to disbursing additional loan proceeds. The trustees' disbursement of the $2.25 million in one lump sum and subsequent failure to account for these proceeds prior to making the $650,000 loan was not a prudent or responsible business practice.

52. The Court finds that no reasonably competent real estate lender, aware of the value of the security for the $650,000 loan, would have made the loan since the security was inadequate.

53. The Court further finds that a reasonably competent real estate lender, acting for the Pension Fund, would not have made the $650,000 loan because of the sub-

stantial risk that the loan could not be repaid without resort to the collateral. At the time the loan was made, S&F's only source of income was the right to rental payments from Seabarm, Inc., S&F's source of income was far less than the amount necessary to service debt payments to the Pension Fund.

## III. DIVERSIFICATION

54. In addition to predicating his request for relief on specific loans extended by the defendant trustees, the manner and terms under which they were granted and extensions and a moratorium involving these loans, the Secretary has focused on the type and character of loans the Pension Fund has invested in. Plaintiff's evidence on lack of diversification of the Pension Fund assets consisted primarily of the expert testimony of Mr. John McMahan, a consultant and manager of real estate investments for individuals and institutions. Diversification, as defined by plaintiff's expert, is the principle or process of placing money in investments with different characteristics or types of risks so as to protect against large losses arising from unforeseen events that could adversely affect any individual investment or class of investments. Mr. McMahan testified that investment diversification requires identification of different classes of investments, that is, categories of investments with different characteristics and opportunities for risk and return. Expert testimony divided these categories into the capital market for non-real estate equities, for non-real estate fixed income and for real estate having both equity and fixed income characteristics.

55. Mr. McMahan further testified that Pension Fund assets, to meet prevailing standards in the field of institu-

tional portfolio management, should be diversified among capital markets. Good investment practice dictates, according to plaintiff's expert, that no more than approximately one-third of the over-all pension fund portfolio be invested in real estate of any kind. In addition, plaintiff established that there is also a broad range of investment possibilities which allow some diversification within the real estate portion of the portfolio. The record shows that pension funds in the United States, on the average, invest a small fraction of their assets in real estate and spread the balance of their assets into other capital markets.

56. Plaintiff argues that the defendant trustees have violated their fiduciary responsibilities by failing to diversify the Pension Fund assets and by such failure have subjected the Fund to excessive risk of financial loss or difficulty. A summary of Trial Exhibit 206, Table 1, indicates that as of June 30, 1975, approximately 45% of the assets of the Local 38 Pension Fund were invested in mortgages; as of June 30, 1976, approximately 53%; as of June 30, 1977, approximately 68%; as of June 30, 1978, approximately 74%; as of June 30, 1979, approximately 76%.[2] (*See also* Pension Fund's Financial Statements for Fiscal Years ending June 30, 1975, June 30, 1979, Exhibits 38-40, 178 and 179, and Stipulation 43.) Trial Exhibit 206, Table 1, also reveals that Pension Fund loans included mortgage loans to Aladdin Hotel Corporation, and Harbour Point Racquet and Yacht Club. The Aladdin Hotel Corporation owns and operates a hotel and gambling casino in

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[2]These figures are an approximation because they include the $500,000 loan from the Pension Fund to the Convalescent Fund which was secured by an assignment of contract rights.

Las Vegas. The loan to Aladdin is secured by a theatre complex adjacent to that hotel and casino complex. The Harbour Point Racquet and Yacht Club owns premises which include racquet ball courts, tennis courts, a spa, a boat harbor and health-athletic facilities.

57. Stipulated facts 45 through 47 show that commencing in 1974, 47% of the Pension Fund portfolio was invested in a loan to the Convalescent Fund secured by second deeds of trust on Convalescent Fund owned realty. As of June 30, 1975, about 45% of the Pension Fund portfolio was invested in loans to the Convalescent Fund; as of June 30, 1976, approximately 53%; as of June 30, 1977, this percentage declined to 49%. At the time the Aladdin loan was made, 69% of the Pension Fund assets were invested in loans to two borrowers, Aladdin Corporation and the Convalescent Fund.

58. The Pension Fund, in addition, owned real estate in downtown San Francisco valued at cost on the 1974-76 financial statements and at market value on the 1977-79 financial statements. The value at year end (June 30) 1974, was about $404,000; 1975—$445,000; 1976—$734,000; 1977—$1,055,000; 1978—$1,067,400; and 1979—$1,067,400.

59. Plaintiff's expert offered testimony that whole mortgages suffer many of the negative characteristics of both real estate equity and fixed income investments without possessing many of the corresponding benefits of such investments. Because they are fixed income investments, mortgages may offer modest, stable returns but are without the possibility of appreciation of the underlying assets because they are not equities. Also, Mr. McMahan explained that mortgages are generally not good inflation

hedges because their market value fluctuates with the prevailing interest rates. It was Mr. McMahan's opinion that the market value of both the 1975 Convalescent Fund mortgage at 8.5% and the $650,000 loan to S&F at 10% have fallen since their issuance due partially to the net increase in interest rates since 1975.

60. Expert testimony also addressed the problem of higher risk levels being encountered with loans on specialized properties such as hotels and resorts in contrast to mortgage loans on investment grade properties. The evidence submitted indicated that risks increase with specialized property loans because they rely on the success of a narrow segment of the economy, the viability of the particular use and specialized nature of the property and the quality of the proposed management. Based on the heavy investment of pension funds in specialized property mortgages and based on expert testimony as to the hazards posed by such investments, the Court finds that the Pension Fund trustees have subjected an increasing number of assets to the same kind of risks and financial difficulties, rather than spreading the risks by investing in a variety of different vehicles. There was sufficient evidence in the record to establish that reasonable diversification of the Pension Fund assets was available in 1974 through 1979 in non-real estate equity and non-real estate fixed income investments.[3] Such diversification would have resulted in returns equal to or in excess of what the Pension Fund was receiving on its recreational real estate ventures and would have spread

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[3]Plaintiff's expert testified that a broad range of non-real estate equity and non-real estate fixed income investments were available to institutional investors, for example, government backed securities, common stock, corporation and other bonds.

the risks associated with the concentration of assets in one kind of investment. In addition to the desirability of diversifying assets among various capital markets, plaintiff established, through Mr. McMahan, that diversification within the whole mortgage loan category is in accordance with prevailing standards in the real estate asset management industry. One way diversification of the mortgage portfolio can be achieved is to keep each loan relatively small in proportion to the total portfolio, thereby allowing investment in a number of properties. Direct whole mortgages usually demand a high minimum investment. As a result, an over-all portfolio must be large enough so that one whole mortgage does not take up a disproportionate share of the over-all portfolio. In Mr. McMahan's opinion, the Pension Fund has too small a portfolio to include any direct whole mortgages. Another way to diversify the mortgage portfolio is to invest in properties with different product types and in different geographic regions. Such a practice spreads the risks arising from physical, legal and economic hazards and is in accordance with accepted real estate asset management practices.

61. Viewed as an individual investment, without reference to the rest of the Pension Fund portfolio, the $1.5 million loan comprised approximately 12% of the over-all portfolio. The Court finds, based on the stipulations, expert testimony and exhibits in this case, that a reasonably competent real estate lender acting for the Pension Fund, would not have made the $1.5 million loan because it concentrated an excessive portion of the portfolio in a single investment, subject to a common set of risks associated with a single geographic area, a single product type

and the specific property involved, Konocti Harbor Inn complex. In making the $1.5 million loan, the trustees failed to spread the risks by diversifying the assets into different classes of investments and different properties.

62. Taken together with the Pension Fund assets already invested, the $1.5 million loan brought the total proportion of the Pension Fund's assets invested in the capital market for real estate to approximately 58%; in whole mortgages, to approximately 53%; and in loans to the Convalescent Fund, to approximately 53% (Exhibit 39, 206 (Table 1)). Based on these figures and the testimony of plaintiff's expert, the Court finds that a reasonable real estate lender, acting for the Pension Fund, would not have made the $1.5 million loan, when viewed in the context of the rest of the Pension Fund portfolio, because it concentrated an excessive proportion of the portfolio in the same capital market (real estate), the same real estate vehicle (whole mortgages), the same geographic region (Clear Lake, California), the same product or property type (resort or hotel), and the same specific property (Konocti Harbor Inn Complex).

63. Viewed as an individual investment, without reference to the rest of the Pension Fund portfolio, the $2.25 million loan to S&F represented approximately 11% of the over-all portfolio (Exhibits 178 and 179 (Pension Fund Financials, June 30, 1978 and 1979); Exhibit 206 (Table I)). It concentrated a large proportion of the portfolio in a single investment, subject to a common set of risks associated with a single geographic location, a single product type, and the specific project and property involved (construction and operation of the Santa Rosa health spa).

64. Taken together with the Pension Fund assets already invested, the $2.25 million loan brought the total proportion of the Fund's assets invested in the capital market for real estate to nearly 80%; in mortgages, to approximately 75%; in mortgages on hotel or resort properties, to approximately 72%; and in mortgages secured by Northern California real estate, to approximately 45%. (Exhibits 178, 179, 206 (Table I); Stip. 43.) Indeed, if the propriety of the $2.25 million loan was in issue, the Court would have found that a reasonably competent mortgage lender, acting for the Pension Fund, would not have made that loan, because, when viewed in the context of the rest of the portfolio, that loan concentrated an excessive proportion of the Fund's assets in Northern California mortgages in specialized properties.

65. Taken together with the $2.25 million loan to S&F, the $650,000 loan brought the total proportion of the Pension Fund portfolio invested in loans to S&F to approximately 14.5% (Exhibits 178, 179, 206 (Table I) ). In light of these figures, the Court finds that a reasonable real estate lender, acting for the Pension Fund, would not have made the $650,000 loan, because, when viewed in conjunction with the first S&F loan, even apart from the rest of the Pension Fund portfolio, the loan increased concentration of an excessive proportion of the portfolio in the spa project, and more greatly subjected Fund assets to the common set of risks associated with that single geographic location, that single product type, and the specific project and property involved (construction and operation of the health spa).

66. Taken together with the assets already invested, and assuming a total portfolio of $20 million by November 20,

1979, the $650,000 loan brought the total proportion of the Fund's total assets invested in the capital market for real estate to approximately 81%; in mortgages, to approximately 76%; in mortgages on certain specialized properties, to approximately 73%; and in mortgages secured by Northern California real estate, to approximately 47% (Exhibits 178, 179, 206 (Table I); Stip. 43). In light of the record in this case, the Court finds that a reasonable real estate lender, acting for the Pension Fund, would not have made the $650,000 loan, because, when viewed in the context of the rest of the Pension Fund portfolio, the loan further heightened the problem posed by the first S&F loan, *i.e.*, it further increased the proportion of the portfolio committed to the same capital market (real estate), the same real estate vehicle (mortgages), the same geographic region (Northern California), and the same product or property type (resort or hotel).

## IV. THE FEASIBILITY STUDY PERFORMED BY DR. SCHWARTZ

67. During 1977, Dr. Ernest Schwartz prepared and submitted to the Pension Fund trustees a "Feasibility and Economic Study of Konocti Harbor Inn Complex". Dr. Schwartz and the trustees agreed he would provide a feasibility study which would inform the trustees in writing of the manner in which the Convalescent Fund could put Konocti Harbor Inn to its best use. The property covered in the study included Konocti Harbor Inn, Lakeside Haven, the Children's Camp, and the remainder of the realty owned by the Convalescent Fund in Lake County.

68. Dr. Schwartz was paid $250,000 by the Pension Fund for the preparation and submission of the study.

Although there is some conflict as to whether this fee included services beyond the report itself, the record is clear that Dr. Schwartz, after submitting the study, gave no advice or guidance to the trustees concerning the contents of the study, did not extensively discuss with the trustees its implementation and did not perform any follow-up service nor submit any updated report. Moreover, as is set out below, defendants imprudently selected Dr. Schwartz to conduct the study and paid far more than they should have for it. Indeed, it is highly questionable whether the Pension Fund, as opposed to the Convalescent Fund, should have paid anything for a study concerning the best use of property belonging to the Convalescent Fund.

69. Prior to the selection of Dr. Schwartz, the trustees neither (a) solicited bids from nor interviewed other persons who could have performed the study; nor (b) took steps to determine how much another firm or person would charge for a comparable study; nor (c) discussed with any consultant or expert the oral proposals made by Dr. Schwartz as to how he would conduct the study; nor (d) reviewed any documents regarding Dr. Schwartz's suitability to prepare the study.

70. Dr. Schwartz, prior to completing the study, never submitted a written description or prospectus regarding the scope or format of the proposed study, and never submitted the names of references or clients the trustees could contact to confirm that Dr. Schwartz had experience in this field.

71. Dr. Schwartz had never performed a written feasibility study before the one concerning Konocti Harbor Inn, had never written a report regarding potential markets and

customers for a recreational facility and had never specialized in advice on or analysis of recreational-resort properties or any other specific type of real estate.

72. Dr. Schwartz, prior to the time he was selected by the trustees, indicated he wanted a fee of $250,000 for preparing the study. The trustees accepted this figure without a lower counter offer, without negotiations, without investigation into other fees charged by qualified experts for similar studies and without requiring a break down of time expenditure. In April 1977, Dr. Schwartz was hired by the trustees. By June 1977, the trustees had disbursed the total sum of $250,000 to him. By September 1977, the study was completed and submitted to the trustees.

73. During the time the feasibility study was being prepared, Dr. Schwartz was actively engaged in the practice of medicine. No record of the total amount of time spent on the feasibility study was maintained by him.

74. Dr. Schwartz was primarily responsible for writing, compiling and editing the study. Expenses incurred by Dr. Schwartz were minimal although $15,000 of the fee was paid to Joseph DeLucca for work performed on the study. DeLucca served as Administrator of the Pension Fund from some time prior to January 1, 1972, until February 1977. No written itemization of Dr. Schwartz's expenses was ever requested or received by the trustees.

75. Plaintiff presented expert testimony through Gordon Kennedy on the prevailing standards for selection of a consultant to perform a feasibility study. The selector generally obtains bids and written proposals from a number of consultants. Mr. Kennedy testified that this allows

the client to compare costs and abilities of various consultants and provides a basis for discussing with the consultant what the client needs, when he needs it, and how much he wants to pay. Plaintiff's expert further stated that the prevailing practice is for a client to withhold some portion of the consultant's fee until satisfactory completion of the study. Given the manner in which the trustees selected Dr. Schwartz and based on the uncontradicted testimony of Mr. Kennedy, the Court finds that the trustees failed to follow generally recognized procedures for selection of a consultant to perform the feasibility study. The Court finds further that the trustees, having paid Dr. Schwartz the full $250,000 prior to the submission of the report, did not act in accordance with accepted standards.

76. Mr. Kennedy testified that a professionally done feasibility study of acceptable quality, covering the same subject areas as the Schwartz study, would have cost the trustees no more than approximately $100,000 in 1977 dollars. In addition to producing a superior report at substantially less cost, other consultants would have provided follow-up services. According to plaintiff's expert, it is standard practice for other competent consultants to confer with a client after submission of a feasibility study, describe the study in detail and correct or revise portions unsatisfactory to the client.

77. At trial, Mr. Kennedy further testified that a professionally done feasibility study of acceptable quality would serve the following functions and include the following content and coverage: It would identify key subject areas and issues; would reach specific conclusions as to each area; would specify when each stage of the project should occur based on detailed projections of cost and cash

flow; would evaluate the risks and probabilities of success of each proposal; would be written in an organized, understandable manner; and would provide the client sufficient analysis and grounds for making informed decisions about the project. (*See* Exhibit 207, Table I; R.T., Oct. 29, 1980, p. 42(15)-72(22).)

78. On the basis of Mr. Kennedy's testimony, a review of the feasibility study, and all the record evidence, the Court finds that the Schwartz study is seriously deficient in the following respects: It largely fails to reach specific conclusions and recommendations as to each key subject area; does not provide any substantial market analysis; does not develop a coordinated program for physical development of the many general proposals set forth in the study nor for financing such development; does not adequately assess the risks and probabilities of success of each proposal; is not written or organized in a sufficiently comprehensible fashion; and fails to provide the trustees sufficient analysis and grounds for making informed decisions as to how to develop Konocti. (*See* Exhibit 207, Table I.)

79. Given the deficiencies of the Schwartz study, Mr. Kennedy testified that in his expert judgment approximately $50,000-$100,000 would have to be expended for correction work to bring the existing study up to par with a professionally competent piece of work, and to provide the trustees sufficient grounds for making investment and development decisions regarding Konocti. On the basis of the foregoing evidence, Mr. Kennedy concluded, and the Court finds, that the trustees should not have paid more than $50,000 for the Schwartz study, as submitted to them.

80. The role of the trustees in the feasibility study transaction with Dr. Schwartz was highly improper. The questionable circumstances surrounding the report typify

a cavalier approach in the expenditure of Pension Fund assets. The trustees, having failed to follow accepted procedures for selection of a consultant and having paid the fee demanded by Dr. Schwartz without any questions or investigation as to its reasonableness, received a feasibility study which expert testimony established was not up to acceptable standards, was seriously deficient in many respects and not worth more than $50,000.

81. The Court finds that the payment of the $250,000 fee to Dr. Schwartz for the Konocti Harbor Inn Feasibility Study constituted a waste of a substantial amount of money belonging to the Pension Fund.

V. UNDIVIDED LOYALTY OF THE TRUSTEES

82. At all times from January 1, 1975 to the present:

(a) Some participants of the Pension Fund have not been participants of the Convalescent Fund;

(f) (sic) some participants of the Convalescent Fund have not been participants of the Pension Fund;

(c) there have been a greater number of participants in the Convalescent Fund than in the Pension Fund.

This stipulation, No. 12(a)(b)(c) of the Joint Pre-trial Statement, provides the basis for plaintiff's claim that the Pension Fund trustees, because they also acted as trustees for the Convalescent Fund, violated their fiduciary duties of undivided loyalty. During the trial, when defense counsel became aware that this stipulation could establish a per se violation of the ERISA statute, he attempted to have his client relieved of the stipulation. The Court afforded defense counsel a hearing, by way of an offer of proof, to determine if this portion of the stipulation should or should not be binding on defendants. After an extended hearing

(R.T., Oct. 28, 1980, p. 248 *et seq.*), it was properly ruled that defendants were bound by this stipulation. Even if the stipulation were not binding on defendants, the record establishes that they used their position to benefit the financially troubled Convalescent Fund and not for the exclusive benefit of the Pension Fund's beneficiaries and participants. This is shown by questionable loans to the Convalescent Fund, and by the described extensions and moratorium. Defendants used their position to benefit the Convalescent Fund both when they served as its trustees and when they served as the "Advisory Committee" to the sole trustee.

## VI. THE TRUSTEES' FITNESS FOR OFFICE

83. The following persons have served as trustees of the Pension Fund during the periods indicated:

| | |
|---|---|
| Joseph P. Mazzola | November 1, 1953 to Present |
| Robert E. Buckley | July 1, 1969 to Present |
| Robert J. Costello | February 1, 1956 to January 27, 1979 |
| William Spencer | May 24, 1972 to Present |
| Williams Jennings | July 1, 1956 to March 1, 1978 |
| O. E. Dehnert | September 29, 1971 to Present |
| V. J. Kazarian | January 22, 1975 to Present |
| Keith Hansen | January 30, 1974 to January 10, 1977 |
| Lawrence J. Mazzola | January 22, 1975 to Present |
| H. J. Riboni | February 27, 1974 to Present |
| Raymond Springer | February 1, 1966 to Present |
| Stewart Smith | July 1, 1959 to April 1, 1978 |
| Fred Castro | September 26, 1976 to Present |
| James Emmons | January 10, 1977 to August 1, 1978 |
| Knute Klienan | May 9, 1978 to approx. August 15, 1979 |
| Greg Speranza | March 28, 1979 to Present |
| Arthur Rud | October 10, 1979 to Present |

84. From on or about January 1, 1975, until on or about November 30, 1978, the Board of Trustees of each of the Funds met on a monthly basis on the same day without any separation of the meetings for the respective Funds other than an oral indication of the termination of one meeting and the commencement of another.

85. The Pension Fund trustees are not aware of and have not established any internal written or unwritten guidelines or policies concerning the amount of Fund assets that appropriately may be invested in debt as compared with equity, or long-term as compared with short-term investments. Specifically with regard to real estate loans, the trustees of the Pension Fund are not aware of any internal written or unwritten guidelines or policies concerning:

(a) the geographic distribution of property securing such loans;

(b) the type of business activity associated with the borrower or with the property securing such loans;

(c) the maturity dates of the various debt instruments in the Fund's portfolio;

(d) the amount of Fund assets appropriately invested in construction loans as compared to permanent loans;

(e) the amount of Fund assets appropriately invested in real estate loans secured by second or lesser mortgages, deeds of trust, or security interests as compared with first mortgages, deeds of trust, or security interests; or,

(f) the amount of Fund assets appropriately invested in real estate loans to the same or related borrowers.

86. At all times since January 1, 1974, the trustees of the Pension Fund have retained ultimate authority and control over the Fund's lending and borrowing of money.

87. From some time prior to January 1, 1972, until February of 1977, Joseph P. DeLuca served as Administrator of the Pension Fund and the Convalescent Fund, as well as the other Local 38 Funds. From on or about February of 1977 to the present, Frank Sullivan has served as Administrator of the Pension Fund and the Convalescent Fund as well as the other Local 38 Funds.

88. Employer trustees testified they owned and operated businesses in the plumbing industry that had billings in excess of one million dollars a year. One trustee had been a Police Commissioner. Having reviewed the trial testimony, the Court finds that the trustees, despite their backgrounds, demonstrated a general lack of knowledge and familiarity with the financial affairs of the Pension Fund and the investment portfolio. For example, one of the trustees testified that he did not learn of the moratorium on payments by the Convalescent Fund until some time in 1980, although it was in fact granted at a much earlier date. *See* R.T., Oct. 23, 1980, at 29-30. The defendants were entitled to consult with the Fund administrator in connection with various loans. However, the record demonstrates that the trustees, in many instances, rubber stamped his advice or recommendations, made no independent evaluation of their own and, bluntly, did not exercise the proper degree of care, skill, prudence or diligence in the management and protection of the assets entrusted to them.

89. The Court's findings in regard to the defendant trustees applies to them both individually and collectively. The Court further finds that their violations, individually and collectively, of their fiduciary obligations are likely to continue in the absence of appropriate remedial measures.

## CONCLUSIONS OF LAW

(Where the context requires, one or more of the following conclusions are findings and conclusions on mixed questions of law and fact.)

1. This matter is within the jurisdiction of this Court pursuant to ERISA, 29 U.S.C. § 1132(e)(1) and (2). The Secretary of Labor is a proper party to institute this action under ERISA, 29 U.S.C. § 1132(a)(2) and (5).

2. Pension Fund is an employee benefit plan within the meaning of ERISA, 29 U.S.C. § 1002(3); Trustee defendants are fiduciaries within the meaning and definition of 29 U.S.C. § 1002(21)(A).

3. As enacted by Congress, the purpose of ERISA is to protect the interests of participants and beneficiaries of employee benefit plans. As a corollary, ERISA establishes standards of conduct for the fiduciaries and subjects them to the jurisdiction of federal courts when their fiduciary duty or action becomes subject to question or inquiry. *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978); *Marshall v. Snyder*, 430 F. Supp. 1224, 1231 (E.D.N.Y. 1977), *aff'd.* 572 F.2d 894 (2d Cir. 1978).

4. Among the responsibilities placed upon pension fund trustees, including the defendant trustees here, are that they collectively act for the exclusive benefit of the beneficiaries and participants, and in so acting, they conduct their affairs with undivided loyalty and in accordance with the "prudent man rule". The trustees are also under a fiduciary duty to minimize the risk of large losses by diversifying the investments of the fund. 29 U.S.C. § 1104(a)(1)(A) & (B); 29 U.S.C. § 1106(b)(2); and 29 U.S.C. § 1104(a)(1)(C.

5. In rendering this opinion, based upon the foregoing findings of fact, the Court concludes as a matter of law that the ERISA standards are to be governed, interpreted and judicially determined both in light of the common law of trusts, and the special nature, purpose and intent of employee benefit plans. *Eaves v. Penn, supra; Marshall v. Teamsters Local 282 Pension Trust Fund* [hereinafter *Teamsters Local 282*], 458 F. Supp. 986, 990 n.8 (E.D.N.Y. 1978).

6. The prudence of the trustee defendants' actions in this case is to be determined by an objective test of prudence under the surrounding circumstances. *II, III Scott, The Laws of Trusts,* (3d Ed. 1967) ("Scott"), §§ 174, 227, 227.1, 227.2 and 227.3. *Bogert, Trusts and Trustees,* (2d Ed. 1975) § 541 ("Bogert").

7. The fact that a trustee may have acted with good intentions is no defense to a common law claim of imprudence if his challenged conduct fell short of that objective standard. Bogert § 541, at 164. The common law trustee was also held to the standard applicable to prudent investors in the particular type of investment involved; thus, if he invested in real estate, his conduct would be judged not merely by standards applicable to investors in general, but by those applicable to prudent real estate investors in particular. Bogert § 672, at 263.

8. The good faith of a fiduciary is not a defense to his imprudent act. *Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, et al.* [hereinafter *Glaziers*], 507 F. Supp. 378 (D. Hawaii, 1980). The law requires the trustee defendants to conform to the standards utilized and followed by prudent and informed

mortgage lenders when they make real estate (*id.* at 384). Failure to so conform was not and is not excused by lack of understanding or experience or inability to evaluate investments.

9. The trustee defendants did not meet the legal requirements of 29 U.S.C. § 1104(a)(1)(A) & (B), despite their individual, personal and diverse business backgrounds.

## I. THE LOANS AND EXTENSIONS OF CREDIT

### A. *Exclusive Benefit and Prudent Man Rules*

10. In making the $1.5 million loan to the Convalescent Fund, the defendant trustees violated § 1104(a)(1)(B) by failing to follow reasonably acceptable procedures. It was an investment fraught with risks which the evidence discloses a reasonably competent lender in their position would not have made. They also violated § 1104(a)(1)(A) by acting for the purpose of benefiting the Convalescent Fund.

11. With respect to the $1.5 million loan, the trustee defendants violated 29 U.S.C. § 1104(a)(1)(A) and (B): (a) because they failed to ascertain the identity and value of the loan security; (b) because on the date the loan was made, based on existing informtion, they knew or should have known the loan presented an unreasonable risk of not being timely and fully paid without resort to the collateral; (c) because they granted the loan below the prevailing interest rate for comparable mortgages at that time; (d) because they acted on both sides of the loan transaction; and (e) because they have consistently transacted business with and for the Convalescent Fund at all relevant times for the purpose of aiding the Convalescent Fund at the expense of the Pension Fund.

12. In granting the 1976 moratorium, the trustees violated § 1104(a)(1)(A) and (B) because they could have, but failed, to obtain for the Pension Fund any changes in the terms of the existing loans which would additionally protect the interests of the lender and compensate for granting the moratorium. Once again, they acted on both sides of the transaction and sought to benefit the Convalescent Fund rather than to protect the best interests of the Pension Fund.

13. In granting the 1978 and 1979 extensions on the due date of the $500,000 note, the trustees violated § 1104(a)(1)(A) and (B) because they could have, but failed to obtain for the Pension Fund any changes in the terms of the $500,000 loan or other loans to the Convalescent Fund, which would have additionally protected the interests of the lender and compensated it for granting the extensions. In doing so, they were greatly influenced by their desire to aid the Convalescent Fund.

14. In making the $650,000 loan to S&F, the trustees violated § 1104(a)(1)(B): by both (a) failing to follow reasonable procedures for underwriting the loan, and by (b) actually making this unreasonably risky loan, which a reasonably competent lender in their position would not have made.

15. The legal conclusion with respect to 29 U.S.C. § 1104(a)(1)(B) is founded upon the fact that with respect to the $650,000 loan, the trustee defendants failed to secure and evaluate relevant information about the loan. Deficiencies in the trustees' underwriting of the loan include the absence of basic documentation such as certified financial statements of the borrower, accurate cost figures for the spa

project, and an accurate economic feasibility study; their failure to insure that S&F would receive sufficient funds from the spa to repay the loan; and their failure to impose any monitoring on S&F's use of the loan proceeds.

16. The trustees' failure to control or monitor any of the S&F loan proceeds particularly disturbs the Court as the commitment of the $650,000 loan followed within four (4) months of the disbursement of the $2.25 million loan proceeds.

17. In addition, the trustees violated 29 U.S.C. § 1104 (a)(1)(B) because the $650,000 loan presented an unreasonable risk that the borrower would be unable to pay the Pension Fund and the collateral would be inadequate if foreclosure occurred. The defendant trustees knew or should have known of this fact based on information in existence at the time the loan was made.

18. In their defense, defendants argue that despite their failure to underwrite the $650,000 and $1.5 million loans pursuant to prevailing standards and despite the risks the loans posed at the time they were entered into, they have not violated their fiduciary duties under ERISA. Defendants undertake to support their position by pointing out that the loans are current and have never been in a position of default. This argument is invalid. Under 29 U.S.C. § 1104 (a)(1)(B) and the applicable case law, the test is whether, in light of the circumstances prevailing when the fiduciary makes his decision, the fiduciary's conduct has subjected fund assets to unreasonable and unjustified risks of loss regardless of whether any loss has occurred. *See Teamsters Local 282, supra* at 991-92. Under 29 U.S.C. § 1104(a)(1)(A)(i), the test is whether defendants acted for the exclusive purpose of benefiting the Pension Fund participants

and their beneficiaries. It is no defense that the Pension Fund has not yet suffered, and, if defendants are lucky, will not suffer any loss on account of the defendants' breaches.

19. For the same reason, the Court must reject defendants' argument regarding the actuarial soundness of the Pension Fund as a second defense to § 1104(a)(1)(A) and (B) violations. The actuarial soundness of the Pension Fund portfolio is totally irrelevant to any determination of whether there has been a violation of the exclusive benefit rule. While a prudent trustee would consider actuarial soundness as one factor in making an investment decision (*see* 29 C.F.R. § 2550.404a-1), that does not excuse defendants' failure to consider many other factors.

20. As another claimed justification for the $1.5 million Convalescent Fund loan, defendants insist that the security for that loan is valuable today and increasingly so over time. Even if true, that would not provide a defense to *prima facie* violations of § 1104(a)(1)(A) and (B) arising from the making of this loan because adequate collateral does not assure a borrower's ability to repay short of foreclosure and does not excuse a violation of the exclusive purpose rule. When making a mortgage loan, the prudent fiduciary seeks a steady, adequate rate of return and not the needless headaches, cost, and uncertainties of foreclosing on, and then disposing of, or managing, an unwanted, troubled property. *See Glaziers, supra* at 385. Similarly, with respect to the $650,000 S&F loan, even if the collateral for that loan were adequate, that would not justify under § 1104(a)(1) the making of that loan because of the excessive risk that S&F would not repay in a full and timely fashion.

B. *Diversification*

21. The statutory obligation imposed on pension fund trustees to diversify plan assets unless it is clearly prudent not to do so is aimed at avoiding losses by having investments in different vehicles and properties. In other words, Congress has determined, by virtue of Section 1104(a)(1)(C), that concentration of assets in a single investment or class of investments exposes plan assets to certain shared risks and that to avoid this problem the assets should be in various investments or classes of investments so as to spread the risks. *Teamsters Local 282, supra,* 458 F. Supp. at 990. Pursuant to this requirement, trustees are required to diversify assets of a plan in circumstances where a high percentage of assets in a particular investment or class of investments creates doubt as to the prudence of the investments. *Id.* at 990.

22. The legislative history sets no inflexible standards or limitations with respect to diversifying plan assets. However, House Conf. Rep. No. 93-1280 93d Cong. 2nd Session, Reprinted (1974) U.S. Code Cong. and Admin. News, pgs. 5038, 5084-85, enumerates the considerations which come into focus when confronted with the diversification requirement:

> "The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a prudent fiduciary must consider the facts and circumstances of each case. The factors to be considered include (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; and (7) the dates of maturity."

The Report further states:

> "A fiduciary usually should not invest the whole or an unreasonably large proportion of the trust property in a single security. Ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. Thus, although the fiduciary may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the plan assets in the shares of corporations engaged in a particular industry. If he is investing in mortgages on real property he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property so that a decline in property values in that district or of that class might cause a large loss."

23. The basic policy underlying this statutory duty, according to the House Report, is to require diversification and if diversification on its face does not exist, the fiduciary trustees have the burden of justifying this lack of investment diversification. Once plaintiff has made out a *prima facie* case of non-diversification, the burden then shifts to defendants to demonstrate this failure was prudent. House Conf. Rep. No. 93-1280, *supra,* reprinted 1974 U.S. Code Cong. and Admin. News, at 5084. Case law has interpreted the defendants' burden as not merely proving the investment prudent but showing there is no risk of large loss resulting from non-diversification. *Glaziers, supra,* 507 F. Supp. at 384.

24. The facts in this case clearly demonstrate that the making of the $1.5 million loan and the $650,000 loan vio-

lated the diversification requirement. Taken alone, the $1.5 million loan, representing 12% of the Pension Fund assets, subjected too large a portion of the over-all portfolio to a common set of risks associated with the Clear Lake property at a time when a broad range of other investment possibilities requiring a smaller investment outlay of funds were available in securities, fixed income instruments and real estate. When viewed in conjunction with other monies loaned by the Pension Fund to the Convalescent Fund, the $1.5 million loan violated § 1104(a)(1)(C) by subjecting a disproportionate amount (approximately 53%) of Pension Fund assets to a common set of risks associated with the same capital market, vehicle, geographic area, product type and property.

25. The making of the $650,000 loan violated the requirements of § 1104(a)(1)(C) by investing a disproportionate amount of plan assets in the real estate market, in mortgages, in Northern California in resorts and in the health spa as an individual property. Viewed only in connection with the $2.25 million S&F loan, the $650,000 loan committed too large a portion of the Pension Fund assets (about 14.5%) to a common set of risks linked to the spa at a time when other investment possibilities were available in securities, fixed income instruments and real estate. Viewed in conjunction with other mortgages in the Pension Fund portfolio, the $650,000 loan violated § 1104(a)(1)(C) by exposing too large a percentage (approximately 76%) of assets to a common set of risks tied to the same capital market and vehicle (real estate mortgages), by exposing approximately 47% of the assets to the common set of risks associated with Northern California real estate, and by exposing approximately 73% of the assets to the common risks associated with hotel, resort and recreation property.

26. In defense, the trustees tried to rebut plaintiff's *prima facie* case with evidence that the $1.5 million and the $650,000 loans were current and could be expected to stay so. As previously pointed out, such an argument is irrelevant to the issue of whether the making of the Convalescent Fund and S&F loans was prudent under § 1104(a)(1)(A) & (B). Defendants' burden of rebutting plaintiff's *prima facie* case also demanded proof that non-diversification of the assets was clearly prudent. Defendants have not met this burden.

C. *Divided Loyalties*

27. 29 U.S.C. § 1106(b)(2) provides:

> "(b) A fiduciary with respect to a plan shall not—
> (2) in his individual or on any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries."

*Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979); *M&R Investment Co., Inc. v. Fitzsimmons, et. al.*, 484 F. Supp. 1041 (D. Nev. 1980) support plaintiff's position that a fiduciary who exercises his duties while in a conflict of interest position prohibited by § 1106(b), has committed a per se violation of that section even without proof that his conduct caused any harm.

28. The factual stipulations referred to in the findings of fact establish that the trustees violated the rule of undivided loyalty embodied in § 1106(b)(2) when they acted on both sides of the $1.5 million loan, the 1976 moratorium and the two extensions on the $500,000 note. This was a per se violation and does not demand extensive discussion. Stand-

ing alone, it might be an insufficient basis for granting plaintiff's request for appointment of an investment manager to oversee the operation of the Pension Fund. However, there is ample proof to warrant the conclusion that defendants have consistently acted to benefit the Convalescent Fund rather than the Pension Fund and can be expected to continue to do so, either as "advisory committee" to the Convalescent Fund's trustee, or when running that plan in the absence of a trustee. The Court considers this probability of future violations as one factor justifying the relief requested by plaintiff.

## II. THE FEASIBILITY STUDY

29. As stated previously, 29 U.S.C. § 1104(a)(1)(B) requires the trustees, in executing their duties with respect to the plan, to act for the sole benefit of the plan and with the care, skill and prudence of a prudent man acting in similar circumstances. These requirements apply to the selection of an individual to conduct a feasibility study for the Pension Fund. The fiduciary trustees are compelled to take reasonable and sufficient steps to obtain the most suitable person they could reasonably be expected to obtain given all the circumstances.

30. Plaintiff's expert delineated the accepted industry standards for selecting a consultant to perform a feasibility study and the Court concludes, having reviewed the actions of the trustees, that the trustees did not meet these standards in selecting Dr. Schwartz.

31. Section 1104(a)(1)(A) required defendants to act for the exclusive purpose of providing benefits to those entitled to receive them and defraying *reasonable* expenses

of administering the plan. By spending an unreasonable amount for the feasibility study, defendants violated that statute. The defendant trustees violated their fiduciary obligations by paying $250,000 for a study which failed to meet professional standards of acceptance. The quality of the study, when viewed with the fee demanded and received by Dr. Schwartz, makes it clear that defendants failed to act in a prudent manner. The facts surrounding this transaction make it clear that there has been a violation of § 1104(a)(1)(A) & (B). And this is so notwithstanding defendants' protestations that they were satisfied with Dr. Schwartz's expertise in the field of real estate investment and therefore did not look any further for another person equally or more qualified and possibly less expensive than Dr. Schwartz to conduct the study.

## III. RELIEF

### A. *Restitution*

32. Section 1109(a) of 29 U.S.C. subjects pension fund trustees to joint and several liability for losses resulting from breaches of their fiduciary duties. The Secretary seeks from the defendant trustees restitution for the loss of Pension Fund income due to their granting the $1.5 million loan below prevailing market rates and their paying excessive fees to Dr. Schwartz for the feasibility study. The $1.5 million loan was made at 8.5%, a point and one-half below the prevailing rate of 10% for comparable loans. The Secretary, calculating the amount of losses from the date the loan was made, seeks $22,500 in interest per year for five (5) years or $112,500.

33. With respect to the feasibility study fee, the Secretary seeks $200,000 in restitution, contending that the trustees paid $250,000 for a study not worth more than $50,000 on the market.

34. In sum, plaintiff asks this Court to order the Pension Fund trustees, in accordance with their dates of tenure as fiduciaries, to pay back to the Fund $312,500, together with pre-judgment interest totaling $57,000.

35. Plaintiff is entitled to the above relief. The plain language of 29 U.S.C. § 1109(a) makes defendants liable for losses resulting from any breach. Contrary to defendants' contention, the absence of self-dealing does not excuse them from liability. *See Marshall v. Cuevas,* No. 77-1401 (D.P.R. March 26, 1979); III Scott on Trusts, §§ 205, 227.1; Bogert, Trusts & Trustees, §§ 541 at 164 (rev. 2d ed. 1978) 706 (rev. 2d ed. 1980); Restatement (Second) of Trusts § 201 (1959). Within 20 days of the date hereof, plaintiff shall submit to the Court and serve on the defendants a proposed Judgment providing for the apportionment of the monetary liability among the defendant trustees.

B. *Indemnification*

36. In addition, the Court deems it appropriate to order the trustee defendants to post a cash or corporate surety bond in the amount of $1,000,000.00 to insure the Fund against all losses that may be suffered in connection with the $1.5 million Convalescent Fund loan and the $650,000 S&F loan.

C. *Attorney's Fees*

37. The Secretary seeks a ruling that neither Pension Fund assets or Convalescent Fund assets be used directly

or indirectly by the defendant trustees to pay their costs and attorney's fees incurred in this litigation. Section 1104(a)(1)(A) requires the fiduciary to discharge his duties "solely in the interest of the participants and beneficiaries" and for the exclusive purpose of "(i) providing benefits. . . , and (ii) defraying reasonable expenses of administering the plan". This section, therefore, prevents reimbursement by a plan to a fiduciary for legal fees and costs incurred by the fiduciary if, under the circumstances, the making of such reimbursement would not be a "reasonable expense of administering the plan". *Cf. Eaves v. Penn*, 587 F.2d 453, 464-65 (10th Cir. 1978) (by enacting a statutory authorization for award of attorney's fees [29 U.S.C. § 1132(g)], Congress intended that the offending party bear the costs of the award); *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 643-44, (W.D. Wis. 1979) (award of fees against a plan, rather than a breaching fiduciary, is to be the exception, not the rule).

38. The defendant trustees and defendant Funds are ordered within thirty (30) days of entry of judgment to inform the Court and plaintiff of the amount of assets from any Local 38 fund that has already been used to pay the legal fees and costs of the individual defendants, the legal fees and costs of any employee benefit plan in connection with this action, and the total costs and attorney's fees incurred by all the defendants in conducting this suit. The Court will determine at a subsequent hearing what portion of these costs and fees, if any, is properly attributable to any employee benefit plan.

D. *Appointment of Investment Manager*

39. Having found that the trustees, individually and collectively, violated and will likely continue to violate their fiduciary duties under ERISA, the Court is empowered with broad discretion in fashioning and awarding equitable or remedial relief. *Freund, supra* at 643. The statute, on its face, goes so far as to sanction the removal of fiduciaries in appropriate situations and the courts have utilized this remedy to protect plan assets. 29 U.S.C. § 1109(a); *Eaves v. Penn, supra,* at 463; *Marshall v. Kelly,* 465 F. Supp. 341, 354 (W.D. Okla. 1978).

40. The Secretary asks that an investment manager be appointed to assume control over the assets of the Pension Fund. The Court is mindful that in considering remedies, primary concern should be given to selecting that remedy which is most beneficial to the plan, the beneficiaries and the participants. *Eaves, supra* at 462. The record in this case makes it clear that the appointment of an independent investment administrator is necessary to protect the plan and the interests of the beneficiaries and participants. One consideration warranting this remedy is the making of the loans (and subsequent extensions and moratorium) between the Convalescent Fund and the Pension Fund by an interlocking set of trustees. A conflict of interest situation exists because these same people are on both sides of the transaction as borrower and lender. Even when the Convalescent Fund has a sole trustee, the trustees of the Pension Fund continue to act as his Advisory Committee. *See* Findings of Fact #14 and 27, *supra.* A position of divided loyalties has arisen which is inconsistent with the independent and undivided loyalty to which the Pension Fund

is entitled. Further facts supporting indeed, requiring appointment of an investment administrator include the lack of diversification of the Pension Fund portfolio, the trustees' failure properly to underwrite loans, their failure to secure the most advantageous interest rates, as well as their failure properly to investigate and evaluate the circumstances surrounding Dr. Schwartz's fee dmand and his feasifailure on the part of the trustees properly to acquit their fiduciary responsibilities in the management of Fund assets—a pattern which the evidence shows will continue absent effective remedial measures. Therefore, it is necessary to order immediate and continuing supervision of Pension Fund investment and financial activities by a competent, impartial and independent administrator or administrators. The administrator(s) may be corporate, partnership, or a combination. The administrator(s) must be of impeccable reputation and must have an established record reflecting a high degree of competence in the investment field.

41. In so ordering, it is *not* intended that the trustees be precluded from exercising functions having nothing to do with the investment, maintenance and protection of Pension Fund assets. It *is* intended that all activities relating to the investment, maintenance and protection of Pension Fund assets shall be under the independent supervision and control of the administrator(s).

Consistent with the foregoing Findings of Fact and Conclusions of Law, the Secretary of Labor shall submit to the Court, within thirty (30) days of the date hereof (after service upon defendants), a proposed Judgment particularizing the manner of selection, duties, remuneration, re-

sponsibilities and authority of the administrator(s) provided for above. The proposed Judgment shall carefully spell out provisions calculated to insure that the administrator(s) will effectively function for the optimum benefit of the Pension Fund in investment, maintenance and protection of all its assets. The proposed Judgment shall not require any participation by the Court in any function of the administrator(s) or the trustee(s). Defendants shall, within twenty (20) days after receipt of plaintiff's proposed Judgment, serve and file objections, if desired, to any provisions of the proposed Judgment pertaining to the manner of selection, duties, remuneration, responsibilities and authority of the administrator(s).

Dated: November 17, 1981.

/s/ Stanley A. Weigel
Judge

## Appendix C

In the United States District Court
For the Northern District of California

No. C-79-134 SAW

Raymond J. Donovan, Secretary of the
United States Department of Labor,
Plaintiff,

vs.

Joseph P. Mazzola, et al.,
Defendants.

[Filed July 6, 1982]

### JUDGMENT

In accordance with the Findings of Fact and Conclusions of Law filed on November 17, 1981, IT IS HEREBY ORDERED that judgment be entered against the defendants as follows:

I. *Restitution*

Subject to the limitations hereinafter stated as to Keith Hansen, Fred Castro and James Emmons, the defendant trustees, Joseph P. Mazzola, Robert E. Buckley, Robert J. Costello, William Spencer, William Jennings, O. E. Dehnert, V. J. Kazarian, Keith Hansen, Lawrence J. Mazzola, H. J. Riboni, Raymond Springer, Stewart Smith, Fred Castro and James Emmons shall, within ninety (90) days of the entry of this judgment, jointly and severally make restitution to the U. A. Local 38 Pipe Pension Trade Fund of San Francisco, Marin, Sonoma and Mendocino Counties

(hereinafter "the Pension Fund") in an amount equal to (a) interest on the outstanding balance of the $1.5 million loan made in 1975 from the Pension Fund to the Convalescent Fund, accruing from the date of the first loan disbursement to the date of this judgment, at the rate of 1.5% simple annual interest; and (b) $200,000.00, plus interest on that amount accruing from July 1, 1977, calculated at the following rate of interest: 7% from July 1, 1977 through January 31, 1978; 6% from February 1, 1978 through January 31, 1980; 12% from February 1, 1980 through January 31, 1982; and 20% from February 1, 1982 through the date of this judgment. Defendant Keith Hansen's obligation to make restitution shall not exceed an amount equal to the interest on the outstanding balance of the $1.5 million loan, calculated as specified in (a) above, accruing from the date of the first loan disbursement to the date of this judgment; that of defendants Fred Castro and James Emmons, respectively, shall not exceed $200,000.00, plus interest thereon, calculated as specified in (b) above, accruing from July 1, 1977 until the date of this judgment.

II. *Liability For Other Losses and Bonding Requirement*

In addition to the restitution specified above, the defendants shall remain jointly and severally liable for all other losses sustained by the Pension Fund due to all breaches of any fiduciary obligation as delineated in the Findings of Fact and Conclusions of Law filed November 17, 1981, in connection with the $1.5 million Convalescent Fund loan and/or the $650,000.00 S & F Spas loan. The Court retains jurisdiction to determine, after due notice and fair hearing, the amount of all such other losses, if any.

The trustee defendants, with sixty (60) days of the entry of this judgment, shall post a cash or corporate surety bond in the amount of $1,000,000.00 to insure the Pension Fund against all such other losses. The bond shall be maintained in effect until the outstanding balance on loans between the Pension Fund and S & F Spas is less than $2.25 million, and until the outstanding balance on loans between the Pension Fund and the Convalescent Fund falls below $4,900.00,* and until neither the Convalescent Fund nor S & F Spas is in default on* any obligation owed to the Pension Fund. Defendant Keith Hansen, however, shall not be responsible to maintain the bond in effect once the outstanding balance on loans between the Pension Fund and the Convalescent Fund falls below $4,900,000.00 and the Convalescent Fund is not in default on any obligation to the Pension Fund; defendant Fred Castro shall not be responsible to maintain the bond in effect once the outstanding balance on loans from the Pension Fund to S & F Spas falls below $2.25 million and S & F Spas is not in default on any abligation owing to the Pension Fund; and defendant James Emmons shall not be responsible to obtain or maintain the bond in effect for any period of time.

In the event that moneys recovered from the bond posted by defendants are insufficient to restore any such other losses, defendants jointly and severally shall be liable to restore any remaining loss to the Pension Fund, except that defendant James Emmons shall not be liable for any such amount, defendant Fred Castro shall only be liable

*Underlined language was added to the judgment, NUNC PRO TUNC, on September 2, 1983.

for losses arising out of the $650,000.00 loan to S & F Spas, and defendant Keith Hansen shall only be liable for losses arising out of the $1.5 million loan to the Convalescent Fund.

III. *Appointment, Powers and Duties of Investment Manager*

Provision is made below for appointment of an investment manager (Manager) who shall have the exclusive power to manage, acquire, and dispose of the assets of the Pension Fund, except as specifically provided pursuant to the plan described below. Immediately upon confirmation of his appointment, the trustees of the Pension Fund shall then and there see to it that the Manager has at all times unrestricted access to all documents, records and books of every character and description directly and/or indirectly relating to Pension Fund assets, liabilities, receipts, income, expenses, etc.

No asset of the Pension Fund shall be transferred or encumbered without the prior written approval of the Manager. The trustees shall have no authority to manage, acquire, or dispose of Pension Fund assets except as may be permitted by written instruction from the Manager in accordance with the plan described in the following paragraph.

The Manager shall promptly work out a plan which will approve in advance, under careful safeguards, those disbursements reasonably necessary to facilitate regularity and efficiency in handling such matters as (1) collection of contributions to the Pension Fund; (2) payment of benefits and processing claims for benefits by the Pension Fund;

(3) compliance with all legal requirements for the establishment and maintenance of the Pension Fund; (4) providing appropriate information to the participants, beneficiaries, contributing employers and fiduciaries of the Pension Fund relating to the Fund's operations; (5) establishing and maintaining records necessary for the operation of the Pension Fund; (6) provision of necessary information about the operations of the Pension Fund to agencies of the federal or state government which have any responsibility relating to such operations; (7) payment of reasonable compensation to the Manager; (8) employment of such administrative, legal, accounting, actuarial and clerical assistance necessary for fulfilling administrative responsibilities; (9) purchases of materials, supplies and equipment in that interest; (10) provision of appropriate insurance protection; (11) maintenance of an adequate reserve fund; and (12) compliance with the terms of this judgment. Although the plan may provide that the responsibility for making such routine disbursements lies with the trustees or the administrator of the Pension Fund, it must specify procedures (1) for providing quarterly estimates, in advance, of such disbursements, (2) for insuring that sufficient Pension Fund assets are available to make the estimated disbursements, and (3) for approving any expenses which exceed the quarterly estimates.

The Manager shall have all powers relating to the Pension Fund assets reasonably necessary to their preservation and to sound investment. Such powers shall include (by way of example and not by way of limitation) the power to make claims, to compromise claims, to bring and defend suits, to foreclose security interests, to incur liabili-

ties and to deny claims other than for benefits under the Pension Fund.

The trustees of the Pension Fund, their agents, successors and assigns, shall not interfere with the Manager in the performance of his duties.

*Powers of the Investment Manager with Respect to Loans from the Pension Fund to the Convalescent Fund*

Upon the appointment of the Investment Manager, the outstanding balance of the $1.5 million and the $500,000.00 loan from the Pension Fund to the Convalescent Fund, and all sums which would have been due and payable from the Convalescent Fund to the Pension Fund, but for the moratorium granted by the Pension Fund, shall be payable immediately. The Manager shall take whatever steps are appropriate with respect to the collection of these sums, and may negotiate at arm's length with the trustee of the Convalescent Fund the terms of any extensions or moratoria on the repayment of these or other sums.

*Selection of the Manager*

A. *Minimum Requirements*

The Manager shall be a person or entity

(1) registered as an investment advisor under the Investment Advisors Act of 1940; or a bank, as defined in that Act; or an insurance company qualified to manage, acquire and dispose of employee benefit plan assets under the laws of more than one state.

(2) having previously served as an investment advisor or investment manager for employee benefit plans with assets subject to his or its control or advice exceeding ten million dollars ($10,000,000.00).

(3) having had substantial experience managing assets or providing investment advice with respect to a variety of investments including real estate, stocks and bonds.

(4) whose fee shall be no more than is reasonable, and shall not exceed the fee charged to similar clients for similar services.

(5) possessing an extensive background and experience in commercial and real estate lending and real estate investment.

(6) expressly willing to acknowledge in writing as a condition to his appointment as Manager, that he or it is a fiduciary with respect to the Pension Fund.

B. *Method of Selection*

Within 45 days of entry of this judgment, the plaintiff, Secretary of Labor, shall furnish to the Court and opposing counsel, a written list of candidates to perform the duties of Manager. The Secretary shall provide the Court and opposing counsel with a full statement in writing concerning the qualifications of each candidate. Within 15 days after these names are furnished, the defendants shall file any objections they may have to any of the candidates identified by the Secretary. Thereafter, the Court may either select one of the candidates provided by the Secretary or request the parties to provide the names of additional candidates.

C. *The Manager's Contract*

Once the Court has selected a Manager, the trustees of the Pension Fund and the Manager shall negotiate the terms of the Manager's contract. Within 30 days of the Manager's selection, the trustees of the Pension Fund

shall submit the proposed contract (or a statement of the points on which they cannot reach agreement) to the Court, with a copy to plaintiff, for resolution by the Court. Nothing in the contract shall be inconsistent with this judgment.

D. *Bond*

Promptly after appointment and before commencing service, the Manager shall obtain an appropriate "errors and omissions" insurance policy in the principal sum of at least $1,000,000.00 to cover liability or losses occurring by reason of any act or omission of the Manager, and the Manager shall be bonded pursuant to § 412 of ERISA, 29 U.S.C. § 1112.

E. *Term of Service*

From the date his contract is approved by the Court, the Manager shall serve for a term of ten (10) years.

F. *Removal or Resignation of the Manager*

The Manager may resign after six months' written notice to the Court and all parties to the instant action. If the Manager gives notice of his intent to resign, he shall continue to serve until the Court appoints a successor. The Manager shall be subject to removal pursuant to § 409 of ERISA, 29 U.S.C. § 1109.

If the Manager is removed or resigns, the Court shall appoint a new Manager according to the procedure set forth above, except that the 45 day period to furnish names of possible successors shall run from receipt of the Manager's notice of intent to resign, or from the date on which the Court files an Order removing the Manager.

IV. *Defendants' Fees and Expenses in Conducting the Litigation*

Within 30 days of entry of judgment, defendants shall inform the Court and plaintiff of the amount of assets of any Local 38 affiliated employee benefit plan that has been used to pay legal fees or other expenses in connection with the conduct of this litigation, and the total expenses and attorney's fees incurred by the defendants in conducting this suit. The Court or a Magistrate designated by the Court will determine what portion of these fees and expenses, if any, should be borne by said assets.

V. *Costs*

Plaintiff's costs in conducting this litigation shall be taxed against the defendant trustees in their individual capacities. Within 30 days of entry of this judgment, plaintiff shall submit to the Court and defendants an itemization of his claimed taxable costs. Defendants shall file their objections and serve a copy on plaintiff within 20 days after plaintiff's itemization is filed. Plaintiff's reply, if any, to defendants' objections shall be filed and served within 7 days after defendants' objections are filed.

VI. *Jurisdiction of Court*

To insure compliance with the provisions and purposes of this judgment, the Court retains jurisdiction to amend it at any time and from time to time upon noticed motion of any party or upon the Court's own motion.

Dated: July 6, 1982.

STANLEY A. WEIGEL

Judge

Office - Supreme Court, U.S.
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ALEXANDER L. STEVAS
CLERK

No. 83-598

# In the Supreme Court of the United States

OCTOBER TERM, 1983

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JOSEPH P. MAZZOLA, ET AL., PETITIONERS

*v.*

RAYMOND J. DONOVAN, SECRETARY OF LABOR,
UNITED STATES DEPARTMENT OF LABOR

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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## QUESTIONS PRESENTED

1. Whether the court of appeals correctly applied the "prudent person" rule, in determining that petitioners, trustees of a pension fund, breached their fiduciary duties under Section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1104(a)(1)(B).

2. Whether ERISA's prohibited transaction provision, 29 U.S.C. 1106(b)(2), establishes a per se prohibition against loans between a pension fund and another fund where the trustees of both funds are identical, but the participants and beneficiaries are not.

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# In the Supreme Court of the United States

OCTOBER TERM, 1983

No. 83-598

JOSEPH P. MAZZOLA, ET AL., PETITIONERS

*v.*

RAYMOND J. DONOVAN, SECRETARY OF LABOR, UNITED STATES DEPARTMENT OF LABOR

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A33) is reported at 716 F.2d 1226. The opinion and judgment of the district court (Pet. App. A34-A89, A90-A98) are unreported.

### JURISDICTION

The judgment of the court of appeals was entered on August 23, 1983. The petition for a writ of certiorari was filed on October 11, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### STATEMENT

1. Petitioners are certain present and former members of the Board of Trustees of the Pension Fund of

Local Union 38 of the United Association of Journeymen and Apprentices of the Plumbing and Pipefitting Industry (Pet. App. A2). The Pension Fund is an "employee benefit plan" within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1002(3), and petitioners, as trustees of the fund, are "fiduciaries" with respect to it pursuant to 29 U.S.C. 1002(21)(A) (Pet. App. A2-A3). From January 1, 1975 (the effective date of ERISA's fiduciary provisions (see 29 U.S.C. 1114)), through November 30, 1978, petitioners simultaneously served as trustees of Local Union 38's Convalescent Fund; after November 30, 1978, they acted as an "Advisory Committee" to a sole trustee of the Convalescent Fund (Pet. App. A3). The participants in the Pension Fund and the Convalescent Fund are not identical; thus, some participants in and contributors to the Pension Fund have not been participants in or contributors to the Convalescent Fund (*id.* at A3, A25, A36-A37).

The Convalescent Fund owns a piece of property in Clear Lake, California, on which it operates a summer camp, a low-cost retirement housing project for participants in the Convalescent Fund, and the Konocti Harbor Inn, a resort hotel that offers rooms at discount rates to Convalescent Fund participants under certain circumstances (Pet. App. A3, A37). For years, the Convalescent Fund's Clear Lake operations have lost substantial sums of money; for example, the Konocti Harbor Inn has lost more than $1 million annually in every year since 1973 (*id.* at A39-A40).

In December 1975, petitioners, in their capacity as trustees of the Convalescent Fund, sought from themselves, in their capacity as trustees of the Pension Fund, a $1.5 million loan from Pension Fund assets (Pet. App. A12). Acting as trustees of the Pension Fund, petitioners granted the loan at 8.5% interest (*id.* at A14, A39). At the time, the interest rate on long-

term commercial mortgages ranged from 9.75% to 10% (*id.* at A14, A43). The Convalescent Fund was in poor financial condition when the loan was granted; it had suffered substantial operating losses and had been unable to make regular payments on previous loans it had obtained from the Pension Fund and from a bank (*id.* at A12, A39-A41). The security given for the loan consisted of the unimproved portion of the Convalescent Fund's Clear Lake property, which did not contain the resort facilities, and which was subject to prior bank loans and had already been pledged as security for an earlier $5.5 million loan from the Pension Fund to the Convalescent Fund (*id.* at A12-A13, A41-A43). Petitioners did not ascertain the value of the property pledged as security for the $1.5 million loan, nor did they determine to what extent the Pension Fund's interest in that property was subordinate to other security interests (*ibid.*).

In October 1976, petitioners, in their capacity as trustees of the Convalescent Fund, sought from the Pension Fund a six-month moratorium on repayment of all outstanding loans; in their capacity as trustees of the Pension Fund, petitioners granted the moratorium without requiring additional security or consideration to protect the Pension Fund (Pet. App. A44-A45). In 1978 and 1979, petitioners granted the Convalescent Fund two extensions to repay a $500,000 loan made by the Pension Fund in December 1974 and due November 1, 1978. The extensions were granted without altering the terms of the loan or requiring additional security. *Id.* at A4, A46-A47.

In June 1979, petitioners loaned $650,000 of Pension Fund assets to S & F Spas, a limited partnership, for the purpose of assisting S & F in the development and promotion of a health spa facility in Santa Rosa, California (Pet. App. A6, A49). Previously, petitioners had approved a $2.25 million loan to S & F (*id.* at A6,

A48-A49). Petitioners approved the $650,000 loan without obtaining a reliable, up-to-date feasibility study, cost estimates, certified financial statements, or market analysis. They failed to monitor S & F's use of the proceeds from the $2.25 million or $650,000 loans. *Id.* at A51. In addition, petitioners failed to obtain adequate security for the $650,000 loan (*id.* at A51-A57).

In April 1977, petitioners commissioned Dr. Ernest Schwartz, a friend of one petitioner and personal physician for another, to prepare a feasibility study to determine how the Convalescent Fund could best use the Konocti Harbor Inn property (Pet. App. A5, A16). Petitioners paid Dr. Schwartz $250,000 for the feasibility study (*ibid.*). A professionally prepared feasibility study of acceptable quality, covering the same subject areas as Dr. Schwartz's study, would have cost no more than $100,000 (*id.* at A67). Petitioners did not inquire into Dr. Schwartz's qualifications to prepare the study, did not solicit bids or interview other persons to perform the study, did not seek information concerning how much another person would have charged for the study, did not negotiate the amount of Dr. Schwartz's fee, and did not consult experts concerning Dr. Schwartz's proposed methodology (*id.* at A16-A17, A64-A66). Dr. Schwartz had never before prepared a written feasibility study and had never specialized in advice on or analysis of recreational-resort property or any other specific type of real estate (*id.* at A65-A66). He kept no time records and did no follow-up work after his report was completed (*id.* at A19, A65-A66). Contrary to prevailing practice, petitioners paid Dr. Schwartz his full fee before the study was completed (*id.* at A20, A66-A67). The study failed to meet professional standards of acceptability in several respects, and approximately $50,000 to $100,000 worth of corrective work would have been required to upgrade the

study into a professionally competent document (*id.* at A19, A67-A69).

2. In January 1979, the Secretary of Labor filed suit in the United States District Court for the Northern District of California, alleging that in authorizing the foregoing investments petitioners had breached various fiduciary duties imposed by ERISA. Based on facts established in an extensive pre-trial stipulation and evidence introduced at trial, the district court held that petitioners had violated several of their fiduciary duties under ERISA and ordered appropriate relief, including restitution of losses to the Pension Fund, posting of an indemnity bond, and appointment of an investment manager (Pet. App. A34-A98).

The district court found that in making the $1.5 million loan to the Convalescent Fund, granting a moratorium on its repayment, and granting unconditional extensions for the repayment of other loans, petitioners had failed to act in accordance with prevailing industry standards exercised by competent real estate lenders in making, pricing, and managing real estate-secured loans (Pet. App. A42-A43). Accordingly, the court held that petitioners had violated 29 U.S.C. 1104(a)(1)(B), which requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The district court also found that petitioners had acted on both sides of the loan transactions and "have consistently transacted business with and for the Convalescent Fund at all relevant times for the purpose of aiding the Convalescent Fund at the expense of the Pension Fund" (Pet. App. A75). This conduct, the court ruled, violated 29 U.S.C. 1104(a)(1)(A), which requires trustees to discharge their duties for the exclusive pur-

pose of benefitting participants in a covered plan and defraying reasonable administrative expenses (Pet. App. A75-A76). The court further held that petitioners had committed a per se violation of the rule of undivided loyalty, embodied in 29 U.S.C. 1106(b)(2), by acting on both sides of the loan transactions between the Convalescent Fund and the Pension Fund (Pet. App. A82-A83).

The district court additionally found that a reasonably competent lender in petitioners' position would not have made the "unreasonably risky" $650,000 loan to S & F and that petitioners had failed "to follow reasonable procedures for underwriting the loan" (Pet. App. A76). Therefore, the court held that in authorizing the loan to S & F, petitioners had violated 29 U.S.C. 1104(a)(1)(B) (Pet. App. A76). The court also held (*id.* at A80-A82) that the $1.5 million and $650,000 loans violated the statutory diversification requirement (29 U.S.C. 1104(a)(1)(C)), which directs fiduciaries to diversify investments so as to minimize the risk of large losses unless it is clearly prudent not to do so.

Finally, the district court found that petitioners had spent an unreasonable amount of money, without adequate investigation, for the services of Dr. Schwartz, and held that this expenditure violated both 29 U.S.C. 1104(a)(1)(A) and (B) (Pet. App. A83-A84).

3. The court of appeals affirmed the district court's decision and order in its entirety, upholding all of the foregoing factual findings as not clearly erroneous (Pet. App. A1-A33). The court held, inter alia, that the district court properly applied ERISA's "prudent person" test in concluding that petitioners had breached their fiduciary duties under 29 U.S.C. 1104(a)(1)(B), and that petitioners had committed a per se violation of 29 U.S.C. 1106(b)(2) by participating in a loan transaction between two trust funds (the Pension Fund and the Convalescent Fund) whose trustees are identical, but

whose participants and beneficiaries are not (Pet. App. A12, A25-A28).

## ARGUMENT

Petitioners do not contend that the decision below conflicts with any decision of this Court or of any other court. The court of appeals' decision, moreover, is correct. Accordingly, further review is unwarranted.

1. Petitioners contend (Pet. 8-9) that even though they acted imprudently in their investment decisions, they may not be found to have violated their fiduciary responsibilities under ERISA absent evidence of "dereliction of duty, gross negligence, or bad faith." Petitioners cite no authority for this proposition, and their argument is clearly without merit.

ERISA requires fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. 1104(a)(1)(B). As the court of appeals held (Pet. App. A10-A12), this explicit statutory language, as well as the legislative history of ERISA, establishes that the standard of care to which petitioners are subject is the "prudent person" test, as developed in the common law of trusts and "bearing in mind the special nature and purposes of employee benefit plans." S. Rep. 93-127, 93d Cong., 1st Sess. 29 (1973); H.R. Rep. 93-1280, 93d Cong., 2d Ses. 302 (1974).[1] Under the common law, trustees making

[1] The courts that have discussed the question have noted that 29 U.S.C. 1104(a)(1)(B) adopts the common law prudent person rule. See, *e.g.*, *Eaves* v. *Penn*, 587 F.2d 453, 457 (10th Cir. 1978); *Morrissey* v. *Curran*, 567 F.2d 546, 547-549 & n.8 (2d Cir. 1977). Cf. *NLRB* v. *Amax Coal Co.*, 453 U.S. 322, 329 (1981) ("Where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court

investment decisions are required to use a reasonable degree of care and skill in selecting investments and must "exercise the caution which a prudent man would exercise where a primary consideration is the preservation of the funds invested." 3 A. Scott, *The Law of Trusts* § 227, at 1806 (3d ed. 1967). Among other things, the trustees' obligations include the duty to investigate independently and to evaluate thoroughly the risks and merits of particular investments in light of available alternatives (see, *e.g.*, *Donovan* v. *Bierwirth*, 680 F.2d 263, 271, 273-276 (2d Cir. 1982), cert. denied, No. 82-422 (Dec. 6, 1982); *Marshall* v. *Glass/Metal Association & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. 378, 384 (D. Hawaii 1980)), and the duty to structure those investments in a manner that similarly situated persons in the relevant field would consider appropriate (*id.* at 384).[2]

The court of appeals correctly held (Pet. App. A12) that the district court properly applied the prudent person test, as to each transaction involved in this case, by considering whether petitioners employed accepted methods to investigate the merits of each investment and whether they structured the investments prudently. Absent "a very obvious and exceptional showing of error," which is clearly not present in this case, the

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must infer, unless the statute otherwise dictates, that Congress meant to incorporate the established meaning of these terms.").

[2] Petitioners' assertion (Pet. 10) that the court of appeals "rejected the notion that ERISA leaves to the trustee any ambit of discretion or business judgment such as the common law accorded to trustees" is baseless. The court correctly recognized (Pet. App. A11 n.4) that, as the cited portion of *Scott on Trusts* explains, the prudent person rule applied to trustees' investment decisions at common law, and the court applied that standard to petitioners' conduct. Moreover, petitioners do not explain how the application of an objective standard of "business judgment" to the established facts of this case would change the result reached by the courts below.

concurrent factual findings of the court of appeals and the district court, determining that petitioners failed to adhere to the applicable standard of care, do not warrant further review. See *Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 336 U.S. 271, 275 (1949).[3]

2. Petitioners' suggestion (Pet. 10) that the district court erred in holding that petitioners failed to diversify investments so as to minimize the risk of large losses, in violation of 29 U.S.C. 1104(a)(1)(C), also does not merit further review. First, petitioners did not raise this argument in the court of appeals, the court of appeals did not consider the question, and petitioners advance no compelling reasons for this Court to address the issue. See, *e.g.*, *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970), and cases cited therein. Second, this fact-bound issue, like the others petitioners present, is plainly not appropriate for review on certiorari. *Berenyi* v. *Immigration Director*, 385 U.S. 630 (1967). In any case, uncontradicted expert testimony established that the investments were inadequately diversified (Pet. App. A57-A64).

3. Petitioners contend (Pet. 12) that the Third Circuit's decision in *Cutaiar* v. *Marshall*, 590 F.2d 523 (1979), was "wrongly decided" and should not have been followed by the courts below. In *Cutaiar*, the court held that a per se violation of the rule of undivided loyalty contained in 29 U.S.C. 1106(b)(2) is estab-

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[3] It would be inappropriate, therefore, for this Court to review petitioners' suggestions (Pet. 9-10) that they did not act imprudently in loaning $1.5 million to the financially troubled Convalescent Fund or $650,000 to S & F Spas, or that they properly paid $250,000 for Dr. Schwartz's "feasibility study." In any event, petitioners' attempt (Pet. 9, 10) to justify the reasonableness of investing in the Convalescent Fund and S & F Spas on the ground that the investments generated both employment for union members and employer contributions to the Pension Fund is not supported by the record or by any findings of the courts below.

lished where there is a transaction between two funds whose trustees are identical, but whose participants and beneficiaries are not. *Cutaiar*, 590 F.2d at 529. But that holding does not require review in this case, because petitioners also violated their duties under 29 U.S.C. 1104(a)(1)(A) and (B). As the court of appeals held (Pet. App. A25), those violations alone justify the relief ordered by the district court.

In any event, it is clear that the rule of per se liability established in *Cutaiar* and followed by the courts below is correct. The statute provides that a fiduciary shall not "act in any transaction involving the plan on behalf of a party * * * whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries." 29 U.S.C. 1106(b)(2). As the court noted in *Cutaiar*, 590 F.2d at 530 (emphasis in original), "[f]iduciaries acting on both sides of a loan transaction cannot negotiate the *best* terms for either plan"; thus, "[e]ach plan must be represented by trustees who are free to exert the maximum economic power manifested by their fund whenever they are negotiating a commercial transaction."

There is no merit, therefore, to petitioners' argument (Pet. 11) that they should have been allowed to present evidence on the "substantial identity" of the participants and beneficiaries of the two funds. As the court recognized in *Cutaiar*, 590 F.2d at 530, "[i]f there is a single member who participates in only one of the plans, his plan must be administered without regard for the interests of any other plan." This requirement of undivided loyalty leaves no room for petitioners' contention that the trustees may properly balance the advantages and disadvantages of a particular transaction to each fund to accomplish an objective "which transcends the interest of a single fund" (Pet. 11).[4]

[4] Contrary to petitioners' contention (Pet. 12), the *Cutaiar* rule does not prohibit interfund transactions or require each

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1983

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fund to have a separate set of trustees. The trustees may seek an exemption, under 29 U.S.C. 1108(a), from ERISA's prohibited transaction provisions, or they may appoint an independent investment manager for one of the funds to represent that fund in all interfund transactions.